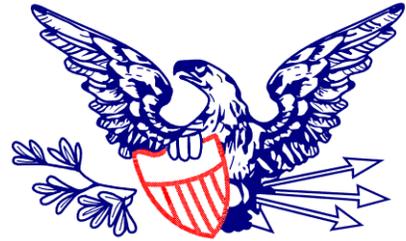


**An American Benefits Consulting
White Paper**



American Benefits Consulting, LLC
99 Park Ave, 25th Floor
New York, NY 10016
212 716-3400
<http://www.abcsys.com>

Group Term Life Insurance: Table I Straddle Testing and Imputed Income for Dependent Life Insurance

Friday, September 24, 2010

Table of Contents

Introduction	2
Imputed Income Definitions and “Straddling”	2
Plan Design Considerations	3
Straddle Testing: Age and Pay Definition	4
Age Definition.....	4
Pay Definition	5
Dependent Life Insurance	5
Whose Age?	6
Child Life	6
Summary	6

Introduction

Many large employers provide a group life insurance plan to employees that includes basic and voluntary life insurance on employees and voluntary life insurance on dependents. It is common knowledge that “imputed income” under section 79 of the Internal Revenue Code must be calculated on employer-paid basic life insurance in excess of \$50,000. However, employers may not know, or understand why, under certain circumstances, imputed income calculations must also consider voluntary life insurance on employees. Employers may also not realize that under certain circumstances imputed income must be calculated for voluntary life insurance on dependents.

Most employers do not wish to calculate imputed income on voluntary life insurance on employees or dependents. This paper addresses how certain aspects of these plans must be structured in order to avoid imputed income on them. This paper assumes that all premium payments are made with **post-tax** dollars.

Section 79 of the Internal Revenue Code governs imputed income on group term life insurance for employees. Section 61 of the Code governs the taxation of life insurance on dependents. We will first address the section 79 employee life concerns and then the section 61 dependent life concerns.

Imputed Income Definitions and “Straddling”

Section 79 of the Code says that an employee must include in his or her income the value of group term life insurance in excess of \$50,000. “Group Term Life Insurance” is specifically defined in the regulations for section 79 (§1.79-1), as follows:

1. It provides a general death benefit that is excludable from gross income...
2. It is provided to a group of employees
3. It is provided under a policy carried directly or indirectly by the employer
4. The amount of insurance provided to each employee is computed under a formula that precludes individual selection...This condition may be satisfied even if the amount of insurance provided is determined under a limited number of alternative schedules...

For this paper, the third item in the definition, and, in particular, the words “policy” and “carried directly or indirectly by the employer” are important.

The regulations say that all the life insurance “obligations” (basic and voluntary life are two obligations) of the same insurer sold in conjunction are combined and considered one “policy”. This is the case even if the basic and voluntary life coverages are provided under separate insurance policies issued by the insurer.

“Carried directly or indirectly by the employer” means that either the employer pays any part of the cost of the insurance or the rates “straddle” Table I. *Straddling Table I means that at least one rate is below Table I and at least one rate is above Table I.*

For example, the following excerpt from a hypothetical rate table demonstrates a straddle:

Age Bracket	Premium Rate	Table I Rate
40-44	\$0.09	\$0.10
45-49	\$0.16	\$0.15

Figure 1: Simple Straddle Example

In this case, the premium rate for the 40-44 age bracket is less than the corresponding Table I rate, while the age 45-49 rate is more than Table I. This is what is meant by a “straddle”.

If an employer wishes to avoid calculating imputed income on voluntary employee life insurance, the voluntary life insurance must be deemed to be provided under a “policy” that is not “carried directly or indirectly” by the employer. How does an employer achieve this?

Plan Design Considerations

First, the employer must be able to deem the voluntary employee life insurance as being provided under a separate policy. Remember that both “obligations” (assuming they are provided by the same insurer) offered to a group of employees must

be considered together. How can the voluntary life be looked at separately?

The regulations provide that the two obligations can be treated as being provided under separate policies if the premiums are properly allocated among such policies. The regulations do not define “properly allocated”, however a subsequent Private Letter Ruling gives the following potential guidelines for evaluating this:

- Rate structures for basic and voluntary Life are self-supporting and don’t subsidize each other
- Premium rates for the coverages are determined separately and independently
- Finances of the coverages are accounted for separately and independently
- Reserves are not shifted between the coverages
- Dividend and rate credits attributable to each of the coverages are determined separately from each other, based on independent retrospective adjustments (if any)

If the above conditions are met, the employer may be able to treat the basic and voluntary life as separate policies. This is the first step to avoiding imputed income on voluntary life.

The second step is making sure the (now separate) voluntary life policy is not “carried directly or indirectly by the employer.” We will assume that the employer pays no portion of the premium. As alluded to above, the policy will be considered to be carried by the employer if the premium rates straddle Table I. *For the rates to NOT straddle Table I, all the rates must be equal to or higher than Table I or, alternatively, all the rates must be equal to or lower than Table I.* The hypothetical voluntary life premium rate tables below illustrate the straddling concept.

Age Bracket	Premium Rate	Table I Rate	Prem. Rate vs. Table I Rate
<25	\$.04	\$.05	Lower
25-29	\$.05	\$.06	Lower
30-34	\$.07	\$.08	Lower
35-39	\$.08	\$.09	Lower
40-44	\$.09	\$.10	Lower
45-49	\$.16	\$.15	Higher
50-54	\$.23	\$.23	Equal

55-59	\$.43	\$.43	Equal
60-64	\$.65	\$.66	Lower
65-69	\$1.26	\$1.27	Lower
70+	\$2.06	\$2.06	Equal

Figure 2: More extensive Straddle Example

Figure 2's table of premium rates straddles Table I because at least one premium rate is higher than its corresponding Table I rate (ages 45-49) while at least one premium rate is lower than Table I (e.g. ages 40-44).

Age Bracket	Premium Rate	Table I Rate	Prem. Rate vs. Table I Rate
<25	\$.06	\$.05	Higher
25-29	\$.07	\$.06	Higher
30-34	\$.09	\$.08	Higher
35-39	\$.10	\$.09	Higher
40-44	\$.11	\$.10	Higher
45-49	\$.16	\$.15	Higher
50-54	\$.23	\$.23	Equal
55-59	\$.43	\$.43	Equal
60-64	\$.67	\$.66	Higher
65-69	\$1.30	\$1.27	Higher
70+	\$2.50	\$2.06	Higher

Figure 3: No Straddle Example

Figure 3's premium rates do not straddle Table I because all the premium rates are equal to or higher than their corresponding Table I rates. Similarly, a premium rate table with all rates equal to or lower than Table I would not straddle Table I.

So, if the voluntary life can be considered to be provided under a separate policy, is 100% employee-paid, and the premium rates don't straddle Table I, then the voluntary employee life insurance can be excluded for imputed income purposes.

As a summary, here is the "path" by which this result is achieved:

1. Basic and voluntary life are considered one policy and both are subject to imputed income (this is the starting point under the Code)

2. The voluntary life can be considered a separate policy if the premiums are properly allocated between basic and voluntary life
3. The voluntary life can be considered NOT carried directly or indirectly by the employer if it is employee-pay-all and the premium rates don't straddle Table I
4. If the voluntary life is a separate policy not carried directly or indirectly by the employer, it is not considered group-term life insurance and is thus not subject to imputed income under Section 79

Straddle Testing: Age and Pay Definition

With respect to the straddle test, there are two special considerations for employers – age definition and pay definition.

Age Definition

If the employer does not determine age for premium purposes on the same basis as the regulations, the voluntary life rates can inadvertently straddle Table I.

When using Table I, the IRS defines age for the entire tax year as the age at the end of the employee's tax year. Let us assume that this is the end of the calendar year for most employees. And, since we are talking about (potential) imputed income for a particular tax year, this would be the age at the end of the year of coverage in question.

For example, for calendar year 2011, for IRS Table I purposes, an employee born in 1951 is considered to be age 60, the employee's age on December 31, 2011.

Some employers define age for premium rate purposes inconsistently with the IRS, using the employee's age at the end of the *prior* year. So, for 2011, an employer may determine someone born in 1951 to be 59. This inconsistency between the "premium age" and the "Table I age" can cause an inadvertent straddle.

For example, consider the following excerpt of a hypothetical premium rate table for an employer that defines age at the end of the prior calendar year.

Age Bracket	Premium Rate	Table I Rate
55-59	\$0.53	\$0.43
60-64	\$0.82	\$0.66

Figure 4: Age Definition Example

For an employee born in 1951, in 2011, the employer uses the \$0.53 rate because the employer considers the employee to be age 59. The IRS considers the employee 60 and would use the 60-64 Table I rate of \$0.66. In this case, the employee's premium rate is lower than the Table I rate (\$0.53 vs. \$0.66).

However, consider the same situation for an employee born in 1952. The employer would use the age 58 rate of \$0.53. The IRS would consider the employee to be age 59, for which the Table I rate is \$0.43. In this case, the employee is paying a rate higher than the Table I rate (\$0.53 vs. \$0.43).

In this case, if an employer has employees in the voluntary life plan born in both 1951 and 1952, the employer is charging at least one employee less than Table I and at least one employee more than Table I. This is the definition of a straddle.

If an employer is currently using age at the end of the prior year, and all the premium rates "appear" to be higher than Table I (meaning that if you look at a side-by-side comparison all the five-year age bracketed premium rates are higher than Table I), the straddle situation described above can be remedied by using age at the end of the current year of coverage for premium purposes.

Pay Definition

Similarly, if the employer does not determine the benefit-based pay for premium purposes on the same basis as the regulations, there may also be an inadvertently straddle of Table I.

Some employers define the employee's pay for premium purposes as a frozen amount at some point in the prior year. For example, payroll deductions for premium will be based on the employee's pay as of July 1 of the prior year. However, this same employer may define the death benefit to be based on the employee's pay at the time of death.

For example, assume an employee's pay on July 1, 2010 is \$100,000 and the employee has chosen 3 times pay for voluntary life. The employer may be calculating payroll deductions in 2011 based on a benefit amount of \$300,000. However, if the employee gets a raise to \$110,000 on March 1, 2011 and dies on May 1, 2011, the death benefit is 3 times \$110,000 or \$330,000. This practice may cause an effective Table I straddle as described below.

Assume that the employer's strategy for not straddling Table I rates is to have all rates equal to or higher than Table I. Further, assume that the premium rate for the age 45-49 age bracket is \$0.16 (the Table I rate for this age bracket is \$0.15). Using the hypothetical example above, the employer would be payroll-deducting \$48.00 per month for premium: $(\$300,000 / \$1,000) \times \$0.16 = \48.00 .

However, the regulations define Table I as "Cost per \$1,000 of *protection* for one month." (emphasis added) Protection would appear to mean the death benefit that would be paid if the employee dies. In this case, that amount is \$330,000. If the employer is collecting \$48.00 for a \$330,000 death benefit, the effective premium rate, per \$1,000 of *protection* for one month, is \$0.145: $\$48.00 / (\$330,000 / \$1,000) = \0.145 .

So, effectively, this employee is paying less than the Table I rate for voluntary life insurance. If an employee with the same July 1 pay of \$100,000 received no raise or a raise of, say, 3%, to \$103,000, such employee would effectively still be paying more than the Table I rate. If this situation were to happen, there would be at least one employee paying less than the Table I rate, and at least one employee paying more than the Table I rate. This is a straddle. This can be remedied by using a consistent definition of pay for premium and death benefit purposes.

Dependent Life Insurance

Many employers may not be aware of the imputed income ramifications of having an employee-pay-all dependent life plan. Life insurance on non-employees is not covered by section 79, however it is covered by section 61 of the code. Particularly, the regulations for

section 61 specifically cover “(the) Cost of group-term life insurance on the life of an individual other than an employee.” The regulations say:

The cost (determined under paragraph (d)(2) of §1.79-3) of group term life insurance on the life of an individual other than an employee (such as the spouse or dependent of the employee) provided in connection with the performance of services by the employee is includible in the gross income of the employee.

Some employers may interpret this to say that there is nothing to do because there is no “cost” provided by the employer since the insurance is employee-pay-all. However, note that the regulation defines what the “cost” is, i.e. determined under paragraph (d)(2) of §1.79-3. This means the cost using the Table I rates.

In a subsequent Private Letter Ruling and Technical Advice Memorandum, the IRS has specifically said that the excess of the cost using the Table I rates over the premium actually paid is considered a fringe benefit subject to tax under section 61 of the code. (This is for non-*de minimis* amounts of coverage, which the IRS has defined in some places to be amounts over \$2,000.)

Given the IRS’s guidance on section 61 income on dependent life insurance, if an employer wishes to NOT calculate imputed income, the premium rates must be equal to or above Table I. Note that the age definition considerations discussed in the previous section apply to dependent life insurance as well. In addition, there are two other considerations.

Whose Age?

Some employers, not knowing the age of spouses covered for life insurance, base the premium rate on the employee’s age. It would appear that the “cost” under Table I would be based on the spouse’s age, not the employee’s age, since it is the spouse who is the insured.

Child Life

In many plans, Child Life Insurance is purchased covering all children of the employee for the stated death benefit for a fixed premium. Thus, the more children the employee has, the lower the per \$1,000 premium rate per person covered. Whether or not the employee is paying a premium rate per \$1,000 per person covered that is lower than Table I will depend on the total premium paid by the employee and the number of children insured.

Summary

There are many pitfalls for employers in navigating the concept of imputed income on employee and dependent life insurance. While ABC cannot and does not offer legal advice, we stand ready to help our current and prospective future clients with these issues.

Despite American Benefit’s expertise in this area, please be sure to seek the advice of Accounting or Legal counsel prior to making any determinations regarding income calculations for employees.

Basic and Voluntary Employee Life

Does the employer wish to treat Basic and Voluntary Life as separate policies and exclude Voluntary Life from imputed income calculations?

Yes

No

Are premiums "properly allocated" between Basic and Voluntary Life?
e-CFR §1.79-0

No

Calculate imputed income considering both Basic and Voluntary Life and employee's Voluntary Life premium contribution.

Yes

Yes

Does the employer pay any part of the cost or do the Voluntary Life rates straddle Table I - i.e. is the Voluntary Life policy carried directly or indirectly by the employer?
e-CFR §1.79-0

No

Imputed Income may be calculated on Basic Life only

Basic and Voluntary Spouse and Child Life

The cost (determined under...§1.79-3) of group-term life insurance on the life of an individual other than an employee...is included in the gross income of the employee."

In effect, this means that there should be imputed income calculated for people paying less than the Table I rate for spouse and/or child life.
e-CFR §1.61-2.

Basic an Voluntary AD&D Coverage

No imputed income because its Accident coverage.
e-CFR §1.106-1.

Workflow for determining imputed income impact on Group Life and AD&D plans. Assumes Basic coverages are 100% employer paid and Voluntary coverages are 100% paid by employee. Assumes plan consists of:

- Basic Life
- Basic AD&D
- Voluntary Employee Life
- Voluntary Spouse and Child Life
- Voluntary AD&D