

Nondiscrimination Testing of Group Term Life Insurance: An Overview

The Internal Revenue Code provides an income tax exclusion for the value of the first \$50,000 of employer-provided group term life insurance coverage. For key employees to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This *FYI In-Depth* describes the nondiscrimination tests for group term life insurance to help employers understand how each test operates and the data they need to collect to conduct the tests.

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Background

Section 79 of the Internal Revenue Code provides an income tax exclusion for the value of the first \$50,000 of employer-provided group term life insurance coverage. The value of employer-provided coverage over \$50,000 is included in the gross income of employees and is subject to tax. The taxable amount of employer-provided group term life insurance is commonly referred to as “imputed income,” because employees are taxed as if they had received the taxable value of the coverage in cash.

Section 79 imposes the following nondiscrimination tests on employer-provided group term life insurance coverage to ensure that benefits are not provided disproportionately to “key employees”:

- **An eligibility test.** The plan must satisfy a numerical test or benefit a sufficient percentage of employees who qualify under an eligibility classification that does not discriminate in favor of “key employees.”
- **A benefits test.** The benefits provided under the plan may not discriminate in favor of key employees.

Satisfaction of the requirements must be demonstrated through testing.

Health and Welfare Nondiscrimination Testing

This is the fifth in a series of publications on the nondiscrimination rules for health and welfare benefits. Our [November 8, 2017 FYI In-Depth](#) provided an overview of the various requirements.

Under a special grandfather rule, group term life coverage provided to certain retirees who became age 55 on or before January 1, 1984 is not subject to either the Section 79 nondiscrimination rules or the \$50,000 exclusion. This special rule does not apply to individuals who retired on or after December 31, 1986 if the plan is discriminatory. In addition, plans maintained by churches for certain church employees are exempt from the nondiscrimination rules. However, this exemption does not apply to employees of church-supported educational institutions above the secondary school level (other than schools for religious training) or of church-supported non-profit medical or hospital facilities.

When is group term life insurance considered “employer-provided”?

Group term life insurance is employer-provided if the policy is “carried directly or indirectly” by the employer. A policy is “carried” by an employer if (1) the employer contributes towards the cost of coverage directly or employees pay for coverage through salary reduction, or (2) the rates charged employees straddle the Table I rates (see below).

Elements of Nondiscrimination Testing

A general overview of each of the elements is set out below.

The Prohibited Group

Unlike other nondiscrimination tests, highly compensated individuals are not included in the prohibited group. Instead, the prohibited group for group term life nondiscrimination testing is limited to “key employees”. A key employee is an employee who, at any time during the current plan year, is:

- An officer of the employer having an annual compensation greater than a specified threshold that is indexed annually for inflation — \$175,000 for 2018
- A 5-percent owner of the employer, or
- A 1-percent owner of the employer having an annual compensation from the employer of more than \$150,000.

No more than 50 employees (or, if less, the greater of 3 or 10 percent of the employees) must be treated as officers.

What are Table I rates?

To ensure a uniform method for calculating the cost of group term life insurance that could be included in an employee’s income, Section 79 regulations include a table (Table I) that sets out the cost per \$1,000 for one month’s group term life insurance protection. These rates, which generally apply to five-year age brackets, are known as the “Table I rates.”

For this purpose, “employer” includes not only the entity employing the individual, but also all other entities that are members of the same controlled group of corporations as the employing entity or trades or businesses that are under the same common control. “Employee” includes not only common-law employees, but also leased employees.

An employee is a 5-percent owner of the employer for a particular year if at any time during such year, he or she owns more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 10 percent of the capital or profits interest in the employer.

Excludable Employees

Section 79 permits the following employees to be disregarded in determining whether group term life insurance coverage satisfies the eligibility test:

- Collectively bargained employees who are not eligible to participate in the plan, if benefits were the subject to good faith collective bargaining
- Employees who have not completed three years of service at the beginning of the plan year
- Part-time employee or seasonal employees
- Nonresident aliens with no U.S.-source earned income from the employer.

Except for collectively bargained employees, it does not appear that the employees must be ineligible to participate in the plan as a prerequisite to being excluded from eligibility testing. Additional guidance would be welcome.

Eligibility Test

To satisfy the Section 79 eligibility test, the group term life insurance coverage must satisfy one of the following:

- Cafeteria plan eligibility test — If group term life insurance coverage is offered through a cafeteria plan that satisfies the cafeteria plan eligibility test, the coverage satisfies the Section 79 eligibility test. For more information about the cafeteria plan eligibility test, see our [February 20, 2018 FYI In-Depth](#).
- 70% test — The plan must benefit at least 70% of all non-excludable employees.
- The 85% test — At least 85% of all non-excludable employees eligible to participate are non-key employees.
- Nondiscriminatory classification test — Under this test, the plan must benefit a classification of employees that does not discriminate in favor of key employees.

The eligibility test generally is administered on a controlled group basis. This means that non-excludable employees from all related employers are taken into account.

Group term life insurance that covers both active and former employees generally must satisfy the eligibility tests for each group separately, except to the extent that the former employees qualify for the special retiree grandfather rule. However, in applying the test for retiree-only coverage, only retired employees (and not all former employees) must be considered.

Required and permissive aggregation. All group term life insurance policies covering one or more common key employees are considered a single plan for nondiscrimination testing purposes. In addition, an employer may treat two or more policies that do not cover a common key employee as a single plan — for example, if an employer has one policy that covers only key employees and a second policy that covers only non-key employees, the two policies can be considered together.

Can retirees be key employees?

Yes. For purposes of nondiscrimination testing, a key employee includes a retiree who was a key employee when he or she retired.

Benefits Test

The purpose of the benefits test is to confirm that benefits are not available to key employees on more favorable terms than to other employees. This is generally a facts-and-circumstances test that considers, for example,

whether key employees receive different or better benefits — or pay less for the same benefits — than others. A plan will not fail the benefits test merely because the amount of life insurance for employees under the plan bears a uniform relationship to the total compensation or the basic or regular rate of compensation for those employees.

When to Run the Tests

Section 79 does not specify when the nondiscrimination tests should be run. Ideally, they would be run before, during and immediately after the close of the plan year. However, most employers do not do this. Those that do not should consider, even before the beginning of the plan year, whether their plan design will likely pass the eligibility and benefits tests based on their demographics and that of other members of their controlled group.

Tax Consequences if Nondiscrimination Test Failed

If a plan fails one of the nondiscrimination tests, key employees will lose the income tax exclusion of the value of the first \$50,000 of employer-provided group term life insurance coverage. Instead, they will have the greater of either the actual cost of all their *employer-provided* coverage or the Table I rates for that coverage included in their income (coverage paid for by the employee on an after-tax basis is not taken into account). Non-key employees will still qualify for all tax advantages applicable to the benefit.

Although amounts included in a key employee's income are not subject to federal income tax withholding, they are subject to withholding for FICA taxes. The IRS has stated that an employer may treat the imputed income amounts as paid either by the pay period, by the quarter, or on any other basis so long as the amounts are treated as paid at least as often as once a year.

In Closing

Employers need to be aware of the Section 79 non-discrimination tests and act to ensure that:

- All employers in the controlled group are included in testing,
- Both the eligibility and benefits tests are satisfied, and
- Testing is completed before the end of the plan year

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