

December 8, 2005

## **Taxable Income on Group Life Insurance in Excess of \$50,000**

Section 79 of the Internal Revenue Service Code provides that, generally, the cost of the first \$50,000 of Group Term Life Insurance is not taxable to an employee. The amounts in excess of \$50,000 are taxed according to a uniform premium schedule referred to as "Table I" (copy attached).

Beginning with the 1984 tax year, however, plans that are determined to discriminate in favor of key employees (with respect to benefits or eligibility to participate) are subject to taxation based on the cost of the entire amount of coverage (with no exemption for the first \$50,000 for key employees). The Tax Reform Act of 1984 further amended Section 79 of the Internal Revenue Code to provide that "key employees" be taxed based on the "actual cost" of Group Term Life Insurance provided by a discriminatory plan. "Actual Cost" is defined as the greater of:

- 1) The average rate per thousand charged for the entire group (or actual cost allocated, according to employee age if your plan is step-rated), or
- 2) The rate per thousand according to Table I (attached).

A "key employee" is defined as an employee who at any time during the current plan years is:

- 1) An officer, if annual compensation from the employer is greater than \$135,000.
- 2) An owner of more than 5 percent of the employer.
- 3) An owner of more than 1 percent of the employer if annual compensation from the employer is greater than \$150,000.

Since it appears your current plan may discriminate in favor of key employees, we wanted to make you aware of these taxation rules.

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You will be required to report the higher of the following as 2005 taxable income for your key employees. This additional income may be reported on a Form 1099 or directly on Form W-2 as miscellaneous income.

- 1) Life Insurance benefit (# of thousands) x Table I rates x # of months covered.
- 2) Life Insurance benefit (# of thousands) x average monthly rate x # of months covered.

Please remember that group term life insurance premiums for amounts above \$50,000 are also subject to FICA tax. FICA tax is applicable on the same basis as Federal Income tax. The maximum taxable wage base for purposes of applying FICA tax in 2005 is \$90,000 for the OASDI portion (6.2% of wages); 100% of an employee's wages are subject to the hospital insurance portion of 1.45%.

In an effort to assist you in calculating the taxes due on the life insurance premiums that your employees may have realized in 2005, we have enclosed the following items:

- A copy of the Table I rates which indicate the imputed income per \$1,000 of coverage
- A sample calculation worksheet for key and non-key employees.
- An example of the taxable income calculation.

Remember, key employees are taxed on the entire employer-sponsored life insurance benefit. Non-key employees are taxed only on employer-sponsored life insurance benefits over \$50,000.

If you currently use a payroll service they may be able to calculate taxable income amounts and deduct them from each employee's paycheck.

If you have any questions or if we may be of further assistance, please contact us at 206-441-6300.

**TABLE I RATES (2005)**

<b>Age *</b>	<b>Rates</b>
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 +	2.06

\* Attained age on the last day of the taxable year



Name	Age on 12-31-05	Total Benefit	Taxable Benefit (Disc. plan)	Table I Cost per \$1000/Mo.	# of Months	Subtotal Taxable Income	Total Annual Taxable Income
<b>Example I:</b>							
John Doe	40	\$70,000	\$70,000	0.10	12	\$84.00	\$84.00
<b>Example II:</b>							
John Doe	40	\$ 60,000	\$60,000	0.10	6	\$36.00	
John Doe	40	\$75,000 <i>(salary changed 7/1/05)</i>	\$75,000	0.10	6	\$45.00	\$81.00

**Example I:**

A. Assumptions

1. Age 40 on December 31, 2005
2. Covered January through December (12 months)
3. \$70,000 benefit during all months covered

B. Calculation

- |  |                          |
|--|--------------------------|
| 1. Total benefit of \$70,000 (Discriminatory plan)         | 70 (in \$1,000's)        |
| 2. <u>Times</u> cost per \$1,000 of protection for 1 month | <u>X \$ .10</u> (age 40) |
| 3. Equals cost for \$70,000 for 1 month                    | \$7                      |
| 4. <u>Times</u> number of months covered                   | <u>X 12</u>              |
| 5. Equals taxable income                                   | \$84.00                  |

**Example II:**

A. Assumptions

1. Age 40 on December 31, 2005
2. Covered all year (12 months)
3. \$60,000 benefit from January through June (6 months),  
\$75,000 benefit for remainder of year (6 months)

B. Calculation

1.	Total Benefit of \$60,000 for first 6 months (Disc. plan)	60 (in \$1,000's)
2.	<u>Times</u> cost per \$1,000 of protection for 1 month	<u>X \$ .10</u> (age 40)
3.	Equals cost for \$60,000 for 1 month	\$6.00
4.	<u>Times</u> number of months covered at \$60,000	<u>X 6</u>
5.	Equals taxable income for first 6 months	\$36.00
6.	Total Benefit of \$75,000 for first 6 months (Disc. plan)	75 (in \$1,000's)
7.	<u>Times</u> cost per \$1,000 of protection for 1 month	<u>X \$ .10</u> (age 40)
8.	Equals cost for \$75,000 for 1 month	\$7.50
9.	<u>Times</u> number of months covered at \$75,000	<u>X 6</u>
10.	Equals taxable income for last 6 months	\$45.00
11.	Taxable Income for the year (sum of 5 and 10)	\$81.00



### **Example for KEY EMPLOYEES - I:**

#### A. Assumptions

1. Age 49 on December 31, 2005
2. Covered January through December (12 months)
3. \$75,000 benefit during all months covered

#### B. Calculation

1. Taxable Benefit (\$75,000)	75 (in \$1,000's)
2. <u>Times</u> cost per \$1,000 of protection for 1 month	<u>X \$.15</u> (age 49)
3. Equals cost for \$75,000 for 1 month	\$11.25
4. <u>Times</u> number of months covered	<u>X 12</u>
5. Equals taxable income	\$135.00

### **Example for KEY EMPLOYEES - II:**

#### A. Assumptions

1. Age 40 on December 31, 2005
2. Covered all year (12 months)
3. \$75,000 benefit from January through June (6 months);  
\$100,000 benefit for remainder of year (6 months)

#### B. Calculation

1. Taxable Benefit of \$75,000 for first six months	75 (in \$1,000's)
2. <u>Times</u> cost per \$1,000 of protection for 1 month	<u>X \$.10</u> (age 40)
3. Equals cost for \$75,000 for 1 month	\$7.50
4. <u>Times</u> number of months covered at \$75,000	<u>X 6</u>
5. Equals taxable income for first 6 months	\$45.00
6. Taxable Benefit of \$100,000 for last 6 months	100 (in \$1,000's)
7. <u>Times</u> cost per \$1,000 of protection for 1 month	<u>X \$.10</u> (age 40)
8. Equals cost for \$100,000 for 1 month	\$10.00
9. <u>Times</u> number of months covered at \$100,000	<u>X 6</u>
10. Equals taxable income for last 6 months	\$60.00
11. Taxable Income for the year (sum of 5 and 10)	\$105.00