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Management Alert

IRS Provides Guidance on Supplemental Life Insurance

By Jennifer A. Kraft and M. John Burgess

Life insurance is a common benefit that employers provide to their employees. Naturally, the provision of this benefit has tax consequences, and a recent private letter ruling from the Internal Revenue Service ("IRS") reminds employers that they must carefully structure their insurance arrangements to avoid some unexpected tax consequences when their employees purchase supplemental insurance.

Basic Life Insurance

Employers often provide group term life insurance to their employees at no cost to the employee, usually with a benefit equal to a percentage of base salary. Internal Revenue Code ("Code") Section 79 governs the taxation of this employer-provided life insurance. An employee can receive up to $50,000 worth of coverage tax-free. The cost of any insurance above $50,000, less any amount paid for the insurance by the employee, is taxable income to the employee. For example, if the employer provides basic coverage of $80,000 at no cost to the employee, the employee is taxed on the cost of $30,000 of insurance. The cost of the insurance is determined under tables published by the IRS in regulations under Code Section 79. The employer is required to report the cost of insurance coverage amounts over $50,000 as taxable imputed income on the employee's Form W-2. Since this amount is treated as wages, it is also subject to Social Security and Medicare taxation (which involves a tax on both the employer and employee).

Supplemental Life Insurance

In addition to providing basic life insurance, employers may give employees the opportunity to separately purchase supplemental group term life insurance (and even insurance on their spouses and dependents), but entirely at the employee's expense. Giving employees the ability to purchase additional insurance, even with after-tax money, could impact the tax consequences for both the employee and the employer because *all* employer plan life insurance coverage (basic and supplemental) generally must be aggregated in determining how the employee is taxed. The rate that the employee pays for the supplemental insurance may be less than the cost determined in the tables under Code Section 79. Even though supplemental insurance, and any insurance on spouses and dependents, is typically paid entirely by the employee, without a clear separation of the basic and supplemental policies, the IRS views the difference between the amount paid by the employee and the Code Section 79 cost as taxable compensation because the lesser cost of the insurance (compared to the Code Section 79 rates) arises in the context of the employment relationship. However, an employer can avoid this problem by electing to treat the policies as separate if the policies are structured so that premiums can be properly allocated among the policies. By doing this, the supplemental insurance can be taken out of Code Section 79 and the employee will not be subject to tax, regardless of whether the cost is below the Code Section 79 rate.

New Private Letter Ruling

Private Letter Ruling 201350032 describes a typical situation and approved the steps that the employer took for the premiums to be considered as properly allocated among policies and avoid aggregation of the policies. It involves a common scenario in which:

- Employees were provided with basic life insurance at no cost to them by the employer.
- Employees could separately purchase supplemental life insurance for themselves (and in some cases, their spouses and dependents) through the voluntary employees beneficiary association (VEBA) that the employer uses to fund certain welfare benefits for active employees and retirees. The employees were responsible for paying the entire cost of the supplemental coverage, and payments for this coverage were taken through after-tax payroll deductions.
- The employer added sections in its employee benefit handbooks describing the availability of the supplemental insurance and provided administrative services to the VEBA as an independent contractor, but did not perform other functions for the supplemental life insurance.
- Even though basic and supplemental insurance coverage was obtained from the same insurance company, the insurance premiums for the basic coverage were calculated separately from the premiums for the supplemental coverage offered through the VEBA.
- The employer is not a party to the supplemental insurance contracts, and the supplemental policies are self-supporting in that the premiums for the basic insurance do not subsidize the supplemental coverage.
- Experience factors for each policy are developed independently, reserves are not shifted between the policies, and dividend and rate credits attributable to each policy are determined separately. Neither the basic coverage nor the supplemental coverage were considered to be “permanent” benefits.

The IRS ruled that under the arrangement, the employer could treat the basic coverage and the supplemental coverage separately for purposes of applying the Code Section 79 rules. Therefore, the employees who purchased supplemental coverage would not be taxed on that coverage. The employees still were subject to tax on the cost of the basic coverage to the extent it exceeds $50,000, since that coverage was paid by the employer. In addition, employees (and the employer) would only be subject to Social Security and Medicare taxes on the amount by which the basic coverage exceeds $50,000. While a private letter ruling only applies to the taxpayer that requested it, the ruling is helpful to other employers because it describes a situation in which the IRS views the separation between the basic and supplemental policies as adequate to avoid aggregation under Code Section 79.

Employers would not expect that employees purchasing supplemental life insurance with their own after-tax dollars could see an income tax impact from this purchase. Therefore, employers who provide both basic and supplemental insurance to their employees should review the structure in this ruling to determine if they should revise the administration of their policies in order to avoid having employee taxation on the purchase of supplemental insurance.

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