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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

SEP 30 1999

Index (UIL) No.: 61.09-31; 79.00-00
CASE MIS No.: TAM-121876-98 / CC:EBEO:B5

District Director
[redacted]

Taxpayer's Name: [redacted]
Taxpayer's Address: [redacted]

Taxpayer's Identification No: [redacted]
Years Involved: [redacted]
Date of Conference: [redacted]

LEGEND:

Employer = [redacted]

Insurance Company = [redacted]

ISSUE:

Whether, under the facts of this technical advice request, the cost of life insurance coverage provided by an employer to its employees under a "group life carve-out program" is includible in the employees' gross income pursuant to the provisions of section 79 of the Internal Revenue Code.

CONCLUSION:

For the years involved, the rules of section 79 of the Code apply in this case to determine the taxation of the life insurance benefits provided to employees under Employer's "group life carve-out program."

FACTS:

Employer maintains a basic group-term life insurance plan for its employees for which Employer pays all premiums. Under this plan, employees are entitled to term life insurance coverage in an amount equal to two times compensation. In addition, Employer sponsors what it calls a "group life carve-out program." Under this program, any employee who has a minimum of five years of service and has a salary of at least

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$50,000 can waive coverage above $50,000 for which he or she is entitled under the basic plan, and replace such excess coverage under the carve-out program.

When an employee becomes eligible to participate in the group life carve-out program, the employee completes a waiver form for amounts above $50,000 under the employer's basic plan. The employee then applies for an individual permanent life insurance policy from Insurance Company. No medical exam is required for an eligible participant age 60 or under when the face value of the policy is $150,000 or less. The employee's waiver of coverage above $50,000 under the basic plan takes effect once the new individual policy is issued from Insurance Company and the first premium is paid.

As part of the group life carve-out program, the employee must enter into a "split-dollar" life insurance agreement with Employer whereby the parties agree that the employee shall be the sole owner of the individual policy and that annual premiums due under the policy shall be paid by Employer. The parties also agree that the employee will execute a collateral assignment of the life insurance policy to the extent of premium amounts paid by Employer. The agreement states that, subject to the assignment, the employee has full ownership rights in the policy, including but not limited to, the right to designate and change the beneficiary, and the right to sell, assign, transfer, borrow against, surrender or cancel the policy. Upon any sale, assignment, or transfer of the policy, all of the employee's interest in the policy and rights and obligations under the split-dollar agreement are vested in the assignee or transferee. Employer may not transfer or assign any interest in the policy or any of its rights or obligations under the agreement to anyone else.

The agreement terminates upon the earlier of (1) mutual consent of the parties; (2) the date the employee attains a specified age; (3) termination of employment with Employer for reasons other than total disability; (4) death of the employee; or (5) reimbursement by the employee of the lesser of the total premiums paid by Employer or the cash surrender value of the policy on the date of termination. In general, if the agreement is terminated for reasons other than the death of the employee or reimbursement by the employee of the lesser of premiums paid or cash surrender value, Employer has the right to receive an amount equal to the lesser of total premiums paid by Employer or the policy's cash surrender value on the date of termination. The employee has 60 days after termination to elect to make such payments within 90 days after termination; or, installment payments over two years, plus interest; or, any other manner mutually agreed upon. If the employee makes no election within 60 days, Employer may enforce its rights to reimbursement from the policy's cash surrender value; provided that in the event the cash surrender value of the policy exceeds the amount payable to Employer, any excess shall be repaid to the employee. Upon receipt of the amounts due, Employer is required to release all of its rights under the collateral assignment. If the

agreement terminates because of the death of the employee, Employer is entitled to receive a portion of the death benefits payable under the policy equal to the total amount of premiums paid by Employer.

The information provided indicates that for the years involved, no policy had a cash surrender value that exceeded the total premiums paid by Employer on that policy.

For the years involved, Employer paid the premiums due on the individual policies involved in the group life carve-out program. Employer reported on each employee's W-2 an amount determined by using so-called "substitute P.S. 58 rates" supplied to it by Insurance Company for purposes of valuing the term protection provided to the employees under that program. For most age groups, the amounts reported on the W-2's are at least four to six times lower than the cost of group-term life insurance as determined under section 79 of the Internal Revenue Code for the years involved.

LAW AND ANALYSIS:

Section 61(a)(1) of the Code provides that gross income means all income from whatever source derived, including compensation for services, including fees, commissions, fringe benefits, and similar items. The definition of gross income is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. Commissioner v. Smith, 324 U.S. 177, 181 (1945).

Section 1.61-2 (b)(2)(ii)(a) of the Income Tax Regulations states the general rule that life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee.

Section 79 of the Code provides special rules for amounts includible in an employee's gross income as a result of employer-provided group-term life insurance. Pursuant to section 79(a), an employee must include in gross income an amount equal to the cost of group-term life insurance on his life provided under a policy (or policies) carried directly or indirectly by his employer; but only to the extent that such cost exceeds the sum of the cost of $50,000 of such insurance, and the amount (if any) paid by the employee for the purchase of the insurance. The cost of the group-term life insurance is determined on the basis of uniform premiums prescribed by regulations. I.R.C. §79(c). Section 79(d)(1) provides that the exclusion for the cost of $50,000 of insurance does not apply to key employees (as defined in section 416(i)(1) of the Code) in the case of a discriminatory group-term plan. In the case of a discriminatory plan, the cost of the insurance includible in a key employee's income is the greater of the cost of the insurance (as prescribed by section 1.79-4T of the regulations), or the

uniform premium cost (as prescribed by section 1.79-3(d)(2) of the regulations). The term "discriminatory group-term life insurance plan" means any plan of an employer for providing group-term life insurance unless the following requirements are met: (A) the plan does not discriminate in favor of key employees as to eligibility to participate; and (B) the type and amount of benefits available under the plan do not discriminate in favor of participants who are key employees. I.R.C. §79(d)(2).

Section 1.79-1(a) of the regulations provides that life insurance is not group-term life insurance for purposes of section 79 of the Code unless it meets the following conditions:

(1) It provides a general death benefit that is excludable from gross income under section 101(a).

(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 formula must be based on factors such as age, years of service, compensation, or position.

Section 1.79-1(b) of the regulations provides that no part of the life insurance provided under a policy that provides a permanent benefit is group-term life insurance unless - -

(1) The policy or the employer designates in writing the part of the death benefit provided to each employee that is group-term life insurance; and

(2) The part of the death benefit that is provided to an employee and designated as the group-term life insurance benefit for any policy year is not less than the difference between the total death benefit provided under the policy and the employee's deemed death benefit at the end of the year.

Section 1.79-0 of the regulations define a number of terms relevant here. Under those definitions, a policy of life insurance is "carried directly or indirectly" by the employer if the employer pays any part of the cost of the insurance directly or through another person.

A "group of employees" is all employees of an employer, or less than all employees if membership in the group is determined solely on the basis of age, marital status, or factors related to employment. Regs. §1.79-0. As a general rule, a group of employees does not include fewer than ten full-time employees. Regs. § 1.79-1(c).

A "permanent benefit' is defined as an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy; however, the following features are not permanent benefits - -

(a) a right to convert (or continue) life insurance after group life insurance coverage terminates;

(b) any other feature that provides no economic benefit (other than current insurance protection) to the employee; or

(c) a feature under which term life insurance is provided at a level premium for a period of five years or less.

Regs. §1.79-0.

The term "policy" is defined as including two or more obligations of an insurer that are sold in conjunction. Obligations that are offered or available to members of a group of employees are sold in conjunction if they are offered or available because of the employment relationship. The actuarial sufficiency of the premium charged for each obligation is not taken into account in determining whether the obligations are sold in conjunction. Obligations may be sold in conjunction even if they are contained in separate documents, each document is filed with and approved by the applicable state insurance commission, or each obligation is independent of any other obligation. Thus, a group of individual contracts under which life insurance is provided to a group of employees may be a policy. Similarly, two benefits provided to a group of employees, one term and the other a permanent benefit, may be a policy. Regs. §1.79-0.

Section 1.79-3 of the regulations prescribes the rules for determining the cost of group-term life insurance to be included in an employee's income. Section 1.79-1(d) prescribes the rules for determining how much an employee receiving permanent benefits must include in income.

Section 1.79-4T of the regulations provides rules, in question and answer format, relating to the nondiscrimination requirements for group-term life insurance. Q&A-5 of those regulations describes circumstances under which separate policies of group-term life insurance of an employer will be considered to be a single plan in determining whether the employer's plan of group-term life insurance is discriminatory. All policies providing group-term life insurance to a common key employee or key employees will be considered a single plan for this purpose. For example, if a key employee receives $50,000 of group-term life insurance coverage under one policy and the same key employee receives an additional $250,000 of coverage under a separate group-term life insurance policy, the two policies will be treated as a single plan in determining whether the group-term life insurance provided by the employer is discriminatory. If it is discriminatory, the key employees covered by either policy will not receive the benefit of section 79(a)(1) of the Code for either policy. A policy that provides group-term life insurance to a key employee and a policy under which the same key employee is eligible to receive group-term life insurance upon separation from service will be considered to provide group-term life insurance to a common key employee.

Q&A-9 of section 1.79-4T provides that a plan of group-term life insurance will be considered not to discriminate in favor of participants who are key employees, as to the

amount of benefits available, if the plan provides for a fixed amount of insurance which is the same for all covered employees. In other circumstances, the determination of whether the plan is nondiscriminatory will be based on all the facts and circumstances. Such plans will be considered not to discriminate in favor of participants who are key employees, as to the amount of benefits available, if the plan contains no group of employees described in the following sentence that, if tested separately, would fail to satisfy the requirements of section 79(d)(2)(A) of the Code. The group subject to separate testing under the preceding sentence consists of a key employee and all other participants (including other key employees) who receive, under the plan, an amount of insurance (as a multiple of compensation) that is equal to or greater than the amount of insurance received by such key employee.

Q&A-9 of section 1.79-4T of the regulations further provides that a plan does not meet the requirements for nondiscrimination as to the type and amount of benefits available under the plan unless all types of benefits (including permanent benefits) and all terms and conditions with respect to such benefits which are available to any participant who is a key employee are also available on a nondiscriminatory basis to non-key employee participants.

Section 101(a) of the Code provides the general rule that gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.

Rev. Rul. 64-328, 1964-2 C.B. 11, considers two major types of so-called "split dollar" arrangements, the endorsement system (under which the employer is named as owner on the life insurance policy) and the collateral assignment system (under which the employee is named as the owner on the policy). The Service notes, therein, that the substance of both types of arrangements is that the employer provides the funds representing the investment element in a life insurance contract, which would, in arm's length dealings, entitle it to the earnings accruing to that element. The effect of the arrangement is that the earnings on the investment element in the contract are applied to provide benefits to the employee. Under both systems generally the employee is not expected to repay the funds provided by the employer except out of the proceeds of the policy or from funds available to the employee by reason of the surrender or loan value of the policy. Under the facts of the particular split-dollar arrangement described in Rev. Rul. 64-328, the employer provides the funds to pay the part of the annual premiums equal to the increase in the policy's cash surrender value each year, and the employee pays the balance, if any, of the annual premiums. The employer is entitled to receive, out of the proceeds of the policy, an amount equal to the policy's cash surrender value, or at least a sufficient part thereof to equal the funds it has provided for premium payments. The employee has the right to name the beneficiary of the balance of any proceeds payable by reason of the employee's death. According to the ruling,

the effect of the arrangement is that the earnings on the investment element in the contract are used to provide all or a portion of the cost of the employee's insurance protection, an economic benefit the value of which must be included in the employee's gross income.

Rev. Rul. 64-328 holds that the value of the benefit received by the employee is an amount equal to the one-year term cost of the life insurance protection to which the employee is entitled from year to year, less the portion, if any, provided by the employee. Rev. Rul. 64-328 states that the one-year term cost of life insurance protection provided through a split dollar arrangement is determined by using the "P.S. 58 cost" found in Rev. Rul. 55-747, 1955-2 C.B. 228. Rev. Rul. 64-328 further concludes that the same income tax results obtain if the transaction is cast in some other form resulting in a similar benefit to the employee.

Rev. Rul. 66-110, 1966-1 C.B. 12, amplified by Rev. Rul. 67-154, 1967-1 C.B. 11, provides that in the arrangement described in Rev. Rul. 64-328 current insurance protection is the only economic benefit that the employee receives and consequently only the value of that benefit is referred to as being includible in the employee's income. However, the employee may receive other benefits, such as cash dividends or additional life insurance, the value of which would likewise be includible in the employee's gross income. Rev. Rul. 66-110 also provides that, if lower, the current published initial issue premium rates charged by the insurer for individual one-year term life insurance available to all standard risks may be substituted for the P.S. 58 cost.

We have concluded that the "substitute P.S. 58 rates" used by Employer do not meet the requirements of Rev. Rul. 66-110, as amplified. However, for the reasons discussed below, we have also concluded the provisions of section 79 of the Code, not the split-dollar revenue rulings, apply to determine the taxation of the benefits provided to the employees under Employer's carve-out program.

A discussion of section 79 of the Code is not included in the analysis of the split-dollar life insurance arrangement discussed in Rev. Rul. 64-328. Under the facts of that revenue ruling, life insurance is provided under a split-dollar arrangement involving only one employee, whereas a number of employees are provided with life insurance benefits under Employer's group-term and group life carve-out programs. Consequently, an analysis of the split dollar arrangements under the rules of section 79 is relevant here.

In order for section 79 of the Code to apply to the life insurance provided to employees under Employer's group life carve-out program, the life insurance must meet the four requirements of section 1.79-1(a) of the regulations for group-term life insurance and, if the insurance provides permanent benefits to employees, must additionally meet the

requirements of section 1.79-1(b) of the regulations.

First, the life insurance provided under Employer's group life carve-out program meets the requirement for group-term life insurance that it provide a general death benefit that is excludable from gross income under section 101(a) of the Code.

Second, the life insurance provided under the carve-out program is provided to a "group of employees," as that term is defined for purposes of section 79 of the Code. The insurance is provided to at least ten employees and the membership in the group being provided the carve-out insurance is based solely on factors related to employment - - namely, employees having a minimum of five years of service and a salary of at least $50,000. Further, the fact that the insurance is provided under individual policies does not disqualify the insurance from being provided to a group of employees. The regulations state that a group of individual contracts under which life insurance is provided to a group of employees may be a policy, as long as they are offered or available because of the employment relationship.

Third, the life insurance provided under that program meets the requirement that it be provided under a policy "carried directly or indirectly" by the employer since Employer pays the premiums on the insurance under the carve-out program,.

Fourth, the amount of insurance provided to each employee under the carve-out program is computed under a formula that precludes individual selection since the coverage under the program is based on compensation.

Finally, for the years involved, the life insurance provided under the group life carve-out program provides no "permanent benefit," as that term is defined in section 1.79-0 of the regulations, that would cause it to be subject to the rules of section 1.79-1(b) of the regulations. Pursuant to the definition of "permanent benefit," any feature that provides no economic benefit (other than current insurance protection) <u>to the employee</u> is not a permanent benefit. For the years involved, no individual policy issued pursuant to the group life carve-out program has a cash surrender value that exceeds the amounts to which Employer is entitled. Thus, an employee has no current right to any of the insurance policy's cash value. Also, if an employee transfers the insurance policy to a third party, the transfer is subject to Employer's rights under the collateral assignment and under the split-dollar agreement, so that the employee cannot receive an economic benefit from the policy's current cash value by transferring the policy. Further, whether an employee will receive any rights in the policy's cash value in the future will depend on the employee's continuing employment with Employer; thus, the employee has no vested rights to future cash value. As a result, current insurance protection is the only economic benefit that was actually or constructively received by the employees for the years involved.

Accordingly, the insurance provided under Employer's group life carve-out program is "group-term life insurance" for purposes of section 79 of the Code. Consequently, the rules of that Code provision must be used to determine the amount includible in an employees' income both for the insurance provided under Employer's basic group-term plan and under the carve-out plan. Pursuant to section 79(d), if the insurance provided by Employer meets the nondiscrimination requirements of section 79(d), the rules of sections 79(a) and 79(c) apply for determining the amount includible in all of the employees' income. If the provision of insurance is discriminatory, the exclusion for the cost of $50,000 of insurance does not apply to key employees, and the cost of the insurance includible in a key employee's income is the greater of the cost of the insurance or the uniform premium cost.

Assuming at least one of Employer's key employees is receiving insurance under the carve-out program, Employer's basic plan and its carve-out program will be considered a single plan for purposes of testing under section 79(d)(2) of the Code to determine whether Employer maintains a discriminatory group-term life insurance plan. Regs. §1.79-4T, Q&A-5. Pursuant to Q&A-9 of section 1.79-4T, a plan does not meet the requirements for nondiscrimination as to the amount of benefits available unless all terms and conditions with respect to all benefits (including permanent benefits) that are available to any key employee are also available to non-key employees. Under the general rule of Q&A-9, the terms and conditions of Employer's plan do not meet the requirements for nondiscrimination as to the amount of benefits available since only employees with a salary of $50,000 or more are entitled to participate in the group carve-out program and potentially obtain permanent benefits in the future. However, the regulations include a special rule that a plan will be considered not to discriminate in favor of participants who are key employees, as to the amount of benefits available, if the group receiving the discriminatory benefits, if tested separately, satisfies the requirements of section 79(d) as to eligibility to participate. Accordingly, whether Employer's basic group-term plan and its carve-out program meet the nondiscrimination requirements of section 79(d) of the Code will depend on whether Employer's group life carve-out program, when tested separately, meets the requirements for a nondiscriminatory eligibility classification as described in section 79(d)(3)(A).

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.