Abstract: Employer-provided life insurance can be a great benefit, with the cost of part of it excluded from an employee's taxable income. Participating employees need to be aware that this exclusion only applies to the first $50,000 in coverage, and the employer-paid cost of the excess will be reported on the employee's Form W-2. This is true even if the life insurance is never received. A sidebar reveals how the value of that taxable income is determined.

When is employer-provided life insurance taxable?

If your company benefits include group term life insurance paid by your employer, a portion of the premiums paid for the coverage may be taxable. Depending on the amount of coverage you're provided, some of it may create undesirable income tax consequences for you.

The cost of the first $50,000 of group term life insurance coverage that your employer pays for is excluded from taxable income and doesn't add anything to your income tax bill. That's good news. But the employer-paid cost of group term coverage over $50,000 is taxable income to you. That means it will be included in the taxable wages reported on your Form W-2 — even if you never actually receive it. In other words, it's "phantom income."

Have you reviewed your W-2?

What should you do if you think the tax cost of employer-provided group term life insurance is too high? First, you should establish if this is actually the case. If a specific dollar amount appears in Box 12 of your Form W-2 (with code "C"), that dollar amount represents your employer's cost to provide you with group-term life insurance coverage of more than $50,000, minus any amount you paid for the coverage. You're responsible for federal, state and local taxes on the amount that appears in Box 12 and for the associated Social Security and Medicare taxes as well.

But keep in mind that the amount in Box 12 is already included as part of your total "Wages, tips and other compensation" in Box 1 of the W-2. It's the amount in Box 1 that is reported on your tax return.

What are your options?

If you decide that the tax cost is too high for the benefit you're getting in return, you should find out whether your employer has a "carve-out" plan. That's a plan that allows selected employees to carve out from the group term coverage. If your employer's plan doesn't offer a carve-out, ask if they'd be willing to create one.

There are several different types of carve-out plans that employers can offer to their employees. For example, the employer can continue to provide $50,000 of group term insurance (since there's no tax cost for the first $50,000 of coverage). Then, the employer can either provide the employee with an individual policy for the balance of the coverage or give the employee the amount the employer would have spent for the excess coverage as a cash bonus that the employee can use to pay the premiums on an individual policy.

You may have questions about this important topic, such as how much your group term life insurance benefit is adding to your income. Contact us for help with this and other questions.

Sidebar How is phantom income calculated?

The cost of employer-provided group term life insurance that will be taxable income to you is determined using the IRS Premium Table based on preset factors such as age. Under these determinations, the amount of taxable phantom income attributed to an older employee is often higher than the premium the employee would pay for comparable coverage under an individual term policy. This tax trap gets worse as the employee gets older and as the amount of his or her compensation increases.