

acquired by exercising such an option. The IRS will not apply these taxes to an exercise before October 23, 2004, of an incentive stock option or an employee stock purchase plan option or to a disposition of stock acquired by such exercise.

Additionally, federal income tax withholding is not required on the income resulting from a disqualifying disposition of stock acquired by the exercise after October 22, 2004, of an incentive stock option or under an employee stock purchase plan option, or on income equal to the discount portion of stock acquired by the exercise, after October 22, 2004, of an employee stock purchase plan option resulting from any disposition of the stock. The IRS will not apply federal income tax withholding upon the disposition of stock acquired by the exercise, before October 23, 2004, of an incentive stock option or an employee stock purchase plan option. However, the employer must report as income in box 1 of Form W-2, (a) the discount portion of stock acquired by the exercise of an employee stock purchase plan option upon disposition of the stock, and (b) the spread (between the exercise price and the fair market value of the stock at the time of exercise) upon a disqualifying disposition of stock acquired by the exercise of an incentive stock option or an employee stock purchase plan option.

An employer must report the excess of the fair market value of stock received upon exercise of a nonstatutory stock option over the amount paid for the stock option on Form W-2 in boxes 1, 3 (up to the social security wage base), 5, and in box 12 using the code "V." See Regulations section 1.83-7.

An employee who transfers his or her interest in non-statutory stock options to the employee's former spouse incident to a divorce is not required to include an amount in gross income upon the transfer. The former spouse, rather than the employee, is required to include an amount in gross income when the former spouse exercises the stock options. See Revenue Ruling 2002-22 and Revenue Ruling 2004-60 for details. You can find Revenue Ruling 2002-22 on page 849 of Internal Revenue Bulletin 2002-19 at [www.irs.gov/pub/irs-irbs/irb02-19.pdf](http://www.irs.gov/pub/irs-irbs/irb02-19.pdf). See Revenue Ruling 2004-60, 2004-24 I.R.B. 1051, available at [www.irs.gov/irb/2004-24\\_IRB/ar13.html](http://www.irs.gov/irb/2004-24_IRB/ar13.html).

For more information about employee stock options, see sections 421, 422, and 423 of the Internal Revenue Code and their related regulations.

## Group-Term Life Insurance Coverage

This exclusion applies to life insurance coverage that meets all the following conditions.

- It provides a general death benefit that is not included in income.
- You provide it to a group of employees. See [The 10-employee rule](#), later.

- It provides an amount of insurance to each employee based on a formula that prevents individual selection. This formula must use factors such as the employee's age, years of service, pay, or position.
- You provide it under a policy you directly or indirectly carry. Even if you do not pay any of the policy's cost, you are considered to carry it if you arrange for payment of its cost by your employees and charge at least one employee less than, and at least one other employee more than, the cost of his or her insurance. Determine the cost of the insurance, for this purpose, as explained under [Coverage over the limit](#), later.

Group-term life insurance does not include the following insurance.

- Insurance that does not provide general death benefits, such as travel insurance or a policy providing only accidental death benefits.
- Life insurance on the life of your employee's spouse or dependent. However, you may be able to exclude the cost of this insurance from the employee's wages as a *de minimis* benefit. See [De Minimis \(Minimal\) Benefits](#), earlier.
- Insurance provided under a policy that provides a permanent benefit (an economic value that extends beyond 1 policy year, such as paid-up or cash surrender value), unless certain requirements are met. See Regulations section 1.79-1 for details.

**Employee.** For this exclusion, treat the following individuals as employees.

1. A current common-law employee.
2. A full-time life insurance agent who is a current statutory employee.
3. An individual who was formerly your employee under (1) or (2), above.
4. A leased employee who has provided services to you on a substantially full-time basis for at least a year if the services are performed under your primary direction and control.

**Exception for S corporation shareholders.** Do not treat a 2% shareholder of an S corporation as an employee of the corporation for this purpose. A 2% shareholder is someone who directly or indirectly owns (at any time during the year) more than 2% of the corporation's stock or stock with more than 2% of the voting power. Treat a 2% shareholder as you would a partner in a partnership for fringe benefit purposes, but do not treat the benefit as a reduction in distributions to the 2% shareholder.

**The 10-employee rule.** Generally, life insurance is not group-term life insurance unless you provide it to at least 10 full-time employees at some time during the year.

For this rule, count employees who choose not to receive the insurance unless, to receive it, they must contribute to the cost of benefits other than the group-term life insurance. For example, count an employee who could receive insurance by paying part of the cost, even if that employee chooses not to receive it. However, do not count an employee who must pay part or all of the cost of permanent benefits to get insurance, unless that employee chooses to receive it.

**Exceptions.** Even if you do not meet the 10-employee rule, two exceptions allow you to treat insurance as group-term life insurance.

Under the first exception, you do not have to meet the 10-employee rule if all the following conditions are met.

1. If evidence that the employee is insurable is required, it is limited to a medical questionnaire (completed by the employee) that does not require a physical.
2. You provide the insurance to all your full-time employees or, if the insurer requires the evidence mentioned in (1), to all full-time employees who provide evidence the insurer accepts.
3. You figure the coverage based on either a uniform percentage of pay or the insurer's coverage brackets that meet certain requirements. See Regulations section 1.79-1 for details.

Under the second exception, you do not have to meet the 10-employee rule if all the following conditions are met.

- You provide the insurance under a common plan covering your employees and the employees of at least one other employer who is not related to you.
- The insurance is restricted to, but mandatory for, all your employees who belong to, or are represented by, an organization (such as a union) that carries on substantial activities besides obtaining insurance.
- Evidence of whether an employee is insurable does not affect an employee's eligibility for insurance or the amount of insurance that employee gets.

To apply either exception, do not consider employees who were denied insurance for any of the following reasons.

- They were 65 or older.
- They customarily work 20 hours or less a week or 5 months or less in a calendar year.
- They have not been employed for the waiting period given in the policy. (This waiting period cannot be more than 6 months.)

**Exclusion from wages.** You can generally exclude the cost of up to \$50,000 of group-term life insurance from the wages of an insured employee. You can exclude the same amount from the employee's wages when figuring social security and Medicare taxes. In addition, you do not have to withhold federal income tax or pay FUTA tax on any group-term life insurance you provide to an employee.

**Coverage over the limit.** You must include in your employee's wages subject to social security and Medicare taxes the cost of group-term life insurance that is more than the cost of \$50,000 of coverage, reduced by the amount the employee paid toward the insurance. Report it as wages in boxes 1, 3, and 5 of the employee's Form W-2. Also, show it in box 12 with code "C."

Figure the monthly cost of the insurance to include in the employee's wages by multiplying the number of thousands of dollars of insurance coverage over \$50,000 (figured to the nearest \$100) by the cost shown in the following table. For all coverage provided within the calendar year, use the employee's age on the last day of the employee's tax year. You must prorate the cost from the table if less than a full month of coverage is involved.

**Table 2-2. Cost Per \$1,000 of Protection For 1 Month**

| <u>Age</u>              | <u>Cost</u> |
|-------------------------|-------------|
| Under 25 . . . . .      | \$.05       |
| 25 through 29 . . . . . | .06         |
| 30 through 34 . . . . . | .08         |
| 35 through 39 . . . . . | .09         |
| 40 through 44 . . . . . | .10         |
| 45 through 49 . . . . . | .15         |
| 50 through 54 . . . . . | .23         |
| 55 through 59 . . . . . | .43         |
| 60 through 64 . . . . . | .66         |
| 65 through 69 . . . . . | 1.27        |
| 70 and older . . . . .  | 2.06        |

You figure the total cost to include in the employee's wages by multiplying the monthly cost by the number of full months' coverage at that cost.

**Example.** Tom's employer provides him with group-term life insurance coverage of \$200,000. Tom is 45 years old, is not a key employee, and pays \$100 per year toward the cost of the insurance. Tom's employer must include \$170 in his wages. The \$200,000 of insurance coverage is reduced by \$50,000. The yearly cost of \$150,000 of coverage is \$270 (\$.15 x 150 x 12), and is reduced by the \$100 Tom pays for the insurance. The employer includes \$170 in boxes 1, 3, and 5 of Tom's Form W-2. The employer also enters \$170 in box 12 with code "C."

**Coverage for dependents.** Group-term life insurance coverage paid by the employer for the spouse or dependents of an employee may be excludable from income as a *de minimis* fringe benefit if the face amount is not more than \$2,000. The part of this coverage that the employee paid on an after-tax basis is also excludable from income.

For this purpose, the cost is figured using the monthly cost table above.

**Former employees.** For group-term life insurance over \$50,000 provided to former employees (including retirees), the former employees must pay the employee's share of social security and Medicare taxes with their federal income tax returns. You are not required to collect those taxes. Use the table above to determine the amount of social security and Medicare taxes owed by the former employee for coverage provided after separation from service. Report those uncollected amounts separately in box 12 on Form W-2 using codes "M" and "N." See the Instructions for Forms W-2 and W-3.

**Exception for key employees.** Generally, if your group-term life insurance plan favors key employees as to participation or benefits, you must include the entire cost of the insurance in your key employees' wages. (This exception generally does not apply to church plans.) When figuring social security and Medicare taxes, you must also include the entire cost in the employees' wages. Include the cost in boxes 1, 3, and 5 of Form W-2. However, you do not have to withhold federal income tax or pay FUTA tax on the cost of any group-term life insurance you provide to an employee.

For this purpose, the cost of the insurance is the greater of the following amounts.

- The premiums you pay for the employee's insurance. See Regulations section 1.79-4T(Q&A 6) for more information.
- The cost you figure using the Table 2-2.

For this exclusion, a key employee during 2010 is an employee or former employee who is one of the following individuals. See section 416(i) of the Internal Revenue Code for more information.

1. An officer having annual pay of more than \$160,000.
2. An individual who for 2010 was either of the following.
  - a. A 5% owner of your business.
  - b. A 1% owner of your business whose annual pay was more than \$150,000.

A former employee who was a key employee upon retirement or separation from service is also a key employee.

Your plan does not favor key employees as to participation if at least one of the following is true.

- It benefits at least 70% of your employees.
- At least 85% of the participating employees are not key employees.

- It benefits employees who qualify under a set of rules you set up that do not favor key employees.

Your plan meets this participation test if it is part of a cafeteria plan (discussed in section 1) and it meets the participation test for those plans.

When applying this test, do not consider employees who:

- Have not completed 3 years of service,
- Are part-time or seasonal,
- Are nonresident aliens who receive no U.S. source earned income from you, or
- Are not included in the plan but are in a unit of employees covered by a collective bargaining agreement, if the benefits provided under the plan were the subject of good-faith bargaining between you and employee representatives.

Your plan does not favor key employees as to benefits if all benefits available to participating key employees are also available to all other participating employees. Your plan does not favor key employees just because the amount of insurance you provide to your employees is uniformly related to their pay.

**S corporation shareholders.** Because you cannot treat a 2% shareholder of an S corporation as an employee for this exclusion, you must include the cost of all group-term life insurance coverage you provide the 2% shareholder in his or her wages. When figuring social security and Medicare taxes, you must also include the cost of this coverage in the 2% shareholder's wages. Include the cost in boxes 1, 3, and 5 of Form W-2. However, you do not have to withhold federal income tax or pay federal unemployment tax on the cost of any group-term life insurance coverage you provide to the 2% shareholder.

## Health Savings Accounts

A Health Savings Account (HSA) is an account owned by a qualified individual who is generally your employee or former employee. Any contributions that you make to an HSA become the employee's property and cannot be withdrawn by you. Contributions to the account are used to pay current or future medical expenses of the account owner, his or her spouse, and any qualified dependent. The medical expenses must not be reimbursable by insurance or other sources and their payment from HSA funds (distribution) will not give rise to a medical expense deduction on the individual's federal income tax return. For more information about HSAs, visit the Department of Treasury's website at [www.treas.gov/offices/public-affairs/hsa](http://www.treas.gov/offices/public-affairs/hsa).

**Eligibility.** A qualified individual must be covered by a High Deductible Health Plan (HDHP) and not be covered