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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9665]

RIN 1545-BG12

Tax Treatment of Qualified Retirement Plan Payment of Accident or Health Insurance Premiums

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations clarifying the rules regarding the tax treatment of payments by qualified retirement plans for accident or health insurance. The final regulations set forth the general rule under section 402(a) that amounts held in a qualified plan that are used to pay accident or health insurance premiums are taxable distributions unless described in certain statutory exceptions. The final regulations do not extend this result to arrangements under which amounts are used to pay premiums for disability insurance that replaces retirement plan contributions in the event of a participant's disability. These regulations affect sponsors, administrators, participants, and beneficiaries of qualified retirement plans.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN FEDERAL REGISTER]**.

Applicability Date: These regulations generally apply for taxable years that begin on or after January 1, 2015. However, taxpayers may elect to apply the

regulations to earlier taxable years. See the “**Effective/Applicability Dates**” section in this preamble for additional information regarding the applicability of these regulations.

FOR FURTHER INFORMATION CONTACT: Michael P. Brewer or Lauson C. Green at (202) 317-6700 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 402(a) of the Internal Revenue Code (Code), as well as conforming amendments under sections 72, 105, 106, 401, 402(c), 403(a), and 403(b).

Section 104(a)(3) provides, in general, that gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness. This exclusion does not apply to amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, or to other amounts received by an employee to the extent the amounts either are attributable to contributions by the employer that were not includible in the gross income of the employee or are paid by the employer.

Section 105(a) provides that, except as otherwise provided, amounts received by an employee through accident or health insurance for personal injuries or sickness are included in gross income to the extent the amounts (1) are attributable to contributions by the employer that were not includible in the gross income of the employee or (2) are paid by the employer.

Section 105(b) generally provides that, except in the case of amounts attributable to deductions allowed under section 213 for any prior taxable year, gross income does not include amounts referred to in section 105(a) if the amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care of the taxpayer and his or her spouse or dependents (as defined in section 152, determined without regard to paragraphs (b)(1), (b)(2), and (d)(1)(B) thereof) and any child (as defined in section 152(f)(1)) of the taxpayer who as of the end of the taxable year has not attained age 27.

Section 106(a) provides that, except as otherwise provided, the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the Income Tax Regulations provides that the gross income of an employee does not include contributions that the employer makes to “an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred” by the employee or the employee’s spouse or dependents.

For purposes of the Code, section 7702B(a) treats a qualified long-term care insurance contract as an accident and health insurance contract, and a plan of an employer providing coverage under a qualified long-term care insurance contract as an accident and health plan with respect to that coverage.

Section 213 generally allows a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer and the taxpayer’s spouse and dependents, to the extent that the expenses exceed 10

percent of the taxpayer's adjusted gross income.¹ Section 213(d)(1) provides that the term "medical care" includes amounts paid for insurance covering medical care (including eligible long-term care premiums with respect to qualified long-term care insurance contracts).

Section 401(a) sets forth requirements for a trust forming part of a pension, profit-sharing, or stock bonus plan to be qualified under section 401(a).

Section 401(h) provides that a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents only if certain enumerated conditions are met. Those conditions include: (1) the aggregate actual contributions for medical benefits (when added to actual contributions for life insurance protection under the plan) may not exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established; (2) a separate account must be established and maintained for such benefits; (3) the employer's contributions to the separate account must be reasonable and ascertainable; (4) it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits; (5) any amount remaining after satisfaction of all liabilities must, under the terms of the plan, be returned to the employer; and (6) special limitations for the accounts of key employees (as defined in section 401(h)) must be satisfied.

¹ The 7.5 percent threshold applicable before 2013 continues to apply through 2016 for individuals age 65 and older. See section 213(f).

Section 402(a) provides, in general, that any amount actually distributed by a qualified plan is taxable under section 72 in the taxable year in which distributed.

Section 72(a) provides that, except as otherwise provided, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract. Sections 72(d) and (e), which apply to any amount received as an annuity and any amount not received as an annuity, respectively, provide rules for determining the portion of any distribution that is not includable in gross income as a recovery of a participant's investment in the contract (generally the amount of the unrecovered after-tax employee contributions) under a qualified employer retirement plan.

Section 402(l) provides a limited exclusion from gross income for distributions from an eligible retirement plan used to pay health or long-term care insurance premiums of an eligible retired public safety officer to the extent that the aggregate amount of the distributions for the taxable year is not in excess of the qualified health insurance premiums of the retired public safety officer and his or her spouse or dependents. The total amount excluded from gross income pursuant to section 402(l) is limited to \$3,000.

Section 1.72-15 provides rules relating to the tax treatment of amounts paid from an employer-established plan to which section 72 applies and which provides for distributions of accident or health benefits. With respect to benefits that are attributable to employer contributions, §1.72-15(d) provides that any amount received as an accident or health benefit is includable in gross income, except to the extent excludable from gross income under section 105(b) (relating to reimbursements of medical care

expenses as defined in section 213(d)).² Section 1.72-15(e) provides that the taxability of benefits that are not accident or health benefits is determined under section 72 without regard to any exclusion under section 104 or 105.

Section 1.401-1(b)(1)(i) provides that a plan is not a pension plan within the meaning of section 401(a) if it provides for the payment of benefits not customarily included in a pension plan, such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except for medical benefits described in section 401(h)).

Section 1.401-1(b)(1)(ii) provides that a profit-sharing plan within the meaning of section 401(a) is primarily a plan of deferred compensation, but that amounts allocated to the account of a participant may be used to provide incidental life or accident or health insurance for the participant and the participant's family. Section 1.401-1(b)(1)(iii) provides that a stock bonus plan is a plan established and maintained by the employer to provide benefits similar to those of a profit-sharing plan.

Rev. Rul. 61-164 (1961-2 CB 99) (see §601.601(d)(2)(ii)(b)) holds that a profit-sharing plan does not violate the incidental benefit rule in §1.401-1(b)(1)(ii) merely because, in accordance with the plan's terms, each participant's account under the plan is charged with the cost of health insurance for the participant under group hospitalization insurance for the employer's employees, provided that the total amount used for life or accident or health insurance for the employee and the employee's family is incidental. The ruling also holds that the use of profit-sharing plan funds to pay for

² Section 1.72-15(d) also refers to benefits excludible under section 105(c) (relating to certain payments unrelated to absence from work) or section 105(d), which was repealed in 1983 (and which related to certain disability payments).

medical insurance for a participant and his or her beneficiary is a distribution within the meaning of section 402.

Rev. Rul. 73-501 (1973-2 CB 127) (see §601.601(d)(2)(ii)(b)) applies the incidental benefit rule to the purchase of life insurance by a profit-sharing plan. The ruling states that “[u]nder a qualified profit-sharing plan, the use of trust funds to pay the cost of life, accident, or health insurance for an employee is a distribution within the purview of section 402 of the Code.”

Rev. Rul. 2003-62 (2003-1 CB 1034) holds that amounts distributed from a qualified retirement plan that the distributee elects to have applied to pay health insurance premiums under a cafeteria plan are includible in the distributee's gross income. The ruling also holds that the same conclusion applies if amounts distributed from the plan are applied directly to reimburse medical care expenses incurred by a participant.

Rev. Rul. 2005-55 (2005-2 CB 284) holds that a profit-sharing plan that provides a sub-account that permits distributions only for the purpose of reimbursing the participant for substantiated medical expenses imposes conditions on the entitlement of the participant to amounts held in the sub-account and, as a result of the conditions, does not meet the nonforfeitability requirements of section 411.

Proposed regulations (REG-148393-06) under section 402(a) (proposed regulations) were published by the Treasury Department and the IRS in the **Federal Register** on August 20, 2007 (72 FR 46421). Corrections to the proposed regulations were published in Announcement 2007-98 (2007-2 CB 896). The Treasury Department

and the IRS received written comments on the proposed regulations and a public hearing was held on December 6, 2007.

After consideration of the comments received in response to the proposed regulations, these final regulations generally adopt the provisions of the proposed regulations with certain modifications as described under the heading "Summary of Comments and Explanation of Provisions."

Summary of Comments and Explanation of Provisions

General Treatment of Accident or Health Insurance

Consistent with the proposed regulations, the final regulations clarify that a payment from a qualified plan for an accident or health insurance premium generally constitutes a distribution under section 402(a) that is taxable to the distributee under section 72 in the taxable year in which the premium is paid. The taxable amount generally equals the amount of the premium charged against the participant's benefits under the plan. If a defined contribution plan pays these premiums from a current year contribution or forfeiture that has not been allocated to a participant's account, then the amount of the premium for each participant will be treated as first being allocated to the participant and then charged against the participant's benefits under the plan.

Therefore, the payment of an accident or health plan premium from unallocated contributions or forfeitures also will constitute a distribution to the participant under section 402(a) that is taxable under section 72 in the taxable year in which the premium is paid.

Like the proposed regulations, these regulations provide that a distribution for the payment of the premiums by a qualified plan generally is not excluded from gross

income under sections 104, 105, or 106. However, the distribution may constitute a payment for medical care under section 213. Furthermore, to the extent that the payment of premiums for accident or health insurance has been treated as a distribution from a qualified plan, amounts received through the accident or health insurance for personal injuries or sickness are excludable from gross income under section 104(a)(3) and are not treated as distributions from the plan.

The general rule that the payment of an accident and health insurance premium from a qualified plan constitutes a distribution that is taxable under section 402 does not apply if another statutory provision provides for a different result. For example, section 402(l) provides an exclusion from gross income, up to \$3,000 annually, for distributions paid directly to an insurer to purchase accident or health insurance or qualified long-term care insurance for an eligible retired public safety officer and his or her spouse or dependents. A similar exclusion applies for medical benefits for retired employees provided from an account described in section 401(h).

In accordance with these regulations, as with the proposed regulations, if a payment of a premium for accident or health insurance is treated as a distribution from the trust, then the insurance contract would not be treated as an investment under which the insurer's payments to the trust are treated as a return on that investment. As a result, payments from such a contract that are made to the trust (rather than made to the medical service provider or the participant as reimbursement for covered expenses) are treated as having been made to the participant and then contributed by the participant to the plan.

Special Rule for Disability Insurance Coverage

The preamble to the proposed regulations requested comments on whether there should be limited exceptions to the general rule in the proposed regulations, including whether there should be an exception for a provision that has the effect of a waiver of premium in the case of disability. All of the commenters that addressed the issue of payment of premiums for disability insurance from a plan recommended an exception for disability insurance arrangements that replace retirement plan contributions, describing these arrangements as having the same effect as a waiver of premiums in the case of disability. For example, commenters described an employer's general disability program that not only provides for wage replacement, but also provides for the purchase of insurance to make payments to a qualified plan in the event of a participant's disability that are intended to replace the contributions that would have been made if the participant was not disabled. These commenters requested that the regulations provide that a participant not be currently taxable on the premiums paid by the plan for this type of disability coverage. Similarly, they recommended the participant not be taxed when payments from the disability insurance contract are allocated to the participant's account after the participant becomes disabled. These comments pointed out that the payments would be taxable when benefits are ultimately distributed from the plan.

The Treasury Department and the IRS agree that the purchase of this type of disability coverage by a qualified plan is distinguishable from the purchase of medical insurance by a plan because the functional purpose of the disability insurance coverage is to replace retirement contributions to the plan, instead of providing medical benefits outside of the plan. Accordingly, these final regulations provide an exception for the

payment of disability insurance premiums from a qualified plan if the insurance contract provides for payment of benefits to be made to the trust in the event of an employee's inability to continue employment with the employer due to disability, provided that the payment of benefits with respect to an employee's account does not exceed the reasonable expectation of the annual contributions that would have been made to the plan on the employee's behalf during the period of disability, reduced by any other contributions made on the employee's behalf for the period of disability within the year. For example, under this standard, the payment of benefits with respect to an employee's account may increase to reflect reasonably expected future salary increases. To the extent these conditions are satisfied, the insurance does not constitute a distribution to which section 402(a) applies and instead will be treated as any other plan investment. However, if the insurance contract provides for payment of benefits that exceed the reasonable expectation of the annual contributions that would have been made to the plan on the employee's behalf during the period of disability, then the exception for disability coverage would not apply and all of the premium payments made to provide the benefits to the employee would be treated as distributed to the employee under section 402(a) and (as described in this preamble) benefits from the coverage paid to the plan would constitute contributions. This limitation on the benefits payable under a contract is consistent with treating the disability coverage as a waiver of premium in case of disability, similar to the provision in §1.408-3(a) under which a contract is not treated as other than an individual retirement annuity merely because it provides for waiver of premium upon disability. Additionally, the limitation means that benefits provided by the plan in the event of disability generally will be

comparable to the disability benefits provided by a qualified disability benefit under a defined benefit plan, as described in section 411(a)(9) and §1.411(a)-7(c)(3).

Some commenters recommended that the exception for disability coverage not result in different tax treatment for plan participants depending upon whether their employer insured or self-insured the disability benefit. The final regulations only address the situation in which payment of premiums is made from the plan. The Treasury Department and the IRS have concluded that, to the extent the insurance premiums are not paid by the plan or out of contributions to the plan, the disability insurance contract is not an asset of the plan and the amounts received by the plan under the disability insurance contract are not properly treated as a return on a plan investment. Instead, in such a case, the amounts paid from the insurance contract to the plan would be treated as contributions to the plan and would be subject to the general rules that apply to qualified plan contributions, including section 415(c). Similarly, to the extent the employer self-insures or makes arrangements to finance the disability coverage other than through third party insurance, the amounts paid to the plan on account of disability would be considered a contribution to the plan and would be subject to the general rules that apply to qualified plan contributions, including section 415(c). Payments to the plan will not be properly characterized as a return on a plan investment in any of these situations.

Conforming Amendments

The regulations contain conforming amendments to the Income Tax Regulations under sections 72, 105, 106, 401, and 402(c). These conforming amendments remove obsolete provisions, as well as cite to the rules in these regulations for determining the

tax treatment of the payment of premiums for accident and health insurance from a qualified plan.³

Conforming amendments to the regulations under sections 403(a) and 403(b) also add a cross-reference applying these rules under section 402(a) to sections 403(a) and 403(b) arrangements. As a result, amounts paid for disability insurance premiums from an annuity or account under section 403(a) or 403(b) do not constitute distributions (and the disability insurance contracts are treated as plan investments) if the requirements applicable to the purchase of disability insurance by qualified plans are met. As in the case of a plan described in section 401(a), if the plan sponsor of an annuity or custodial account under section 403(a) or section 403(b) financed the disability protection by paying premiums for disability insurance that provides coverage to protect against a loss of contributions during a period of disability, then the benefits paid by the disability insurer would be treated as employer contributions to the annuity or account. However, if the premiums for the disability insurance were paid from the annuity or account in accordance with the rules that apply to qualified plans, then the benefits paid by the disability insurer will be treated as a return on plan investment.

In addition, the regulations revise the first sentence of §1.106-1 in order to update the definition of the term “dependent” to reflect section 207 of the Working Families Tax Relief Act of 2004, Public Law No. 108-311 (118 Stat. 1166 (2004)) and Notice 2004-79 (2004-2 CB 898) and to reflect the amendment of section 105(b) made

³ The regulations do not alter the incidental benefit rule of §1.401-1(b)(1)(ii) (which provides that a profit-sharing plan may provide incidental life or accident or health insurance for the participant and the participant’s family) nor do they alter the tax treatment of the payment of life insurance. For the tax treatment of payments for life insurance, see section 72(m)(3) and §1.72-16.

by section 1004(d)(1) of the Health Care and Education Reconciliation Act of 2010, Public Law No. 111-152 (124 Stat. 1029 (2010)), to include certain children who have not attained age 27. For periods before the applicability date of the regulations, taxpayers can rely on the interpretation of this latter provision set forth in Notice 2010-38 (2010-20 IRB 682).

These regulations also include a cross-reference to section 402(l) and amend §1.402(c)-2, Q&A-4, to add distributions of premiums for accident or health insurance under §1.402(a)-1(e)(1) to the list of items that are not eligible rollover distributions.

Effective/Applicability Date

The regulations apply for taxable years beginning on or after January 1, 2015. No inference should be drawn that the payment of accident or health premiums from a qualified plan does not constitute a taxable distribution if made in an earlier taxable year. However, taxpayers may elect to apply the regulations to earlier taxable years.

Statement of Availability of IRS Documents

The recently issued IRS notices and revenue rulings cited in this preamble are published in the Internal Revenue Bulletin or Cumulative Bulletin and are available from the Superintendent of Documents, P.O. Box 979050, St. Louis, MO 63197-9000, or by visiting the IRS website at <http://www.irs.gov>.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because

these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Michael P. Brewer and Lauson C. Green, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART I--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.72-15 is amended by:

1. Revising the last sentence of paragraph (a).
2. Revising paragraph (d).
3. Removing and reserving paragraph (f).
4. Revising paragraphs (h) and (i).

The revisions read as follows:

§1.72-15 Applicability of section 72 to accident or health plans.

(a) Applicability of section. * * * Paragraphs (d), (h), and (i) of this section apply for taxable years beginning on or after January 1, 2015.

* * * * *

(d) Accident or health benefits attributable to employer contributions. Any amounts received as accident or health benefits and not attributable to contributions of the employee are includible in gross income except to the extent that the amounts are excludable from gross income under section 105(b) or (c) and the regulations under those sections. See §1.402(a)-1(e) for rules relating to the use of a qualified plan under section 401(a) to pay premiums for accident or health insurance.

* * * * *

(h) Medical benefits for retired employees, etc. See §1.402(a)-1(e)(2) for rules relating to the payment of medical benefits described in section 401(h) under a qualified pension or annuity plan.

(i) Special rules--(1) In general. For purposes of section 72(b) and (d) and this section, the taxpayer must maintain such records as are necessary to substantiate the amount treated as an investment in the taxpayer's annuity contract.

(2) Delegation to Commissioner. The Commissioner may prescribe a form and instructions with respect to the taxpayer's past and current treatment of amounts received under section 72 or 105, and the taxpayer's computation, or recomputation, of the taxpayer's investment in his or her annuity contract. This form may be required to be filed with the taxpayer's returns for years in which the amounts are excluded under section 72 or 105.

§1.105-4 [Removed]

Par. 3. Section 1.105-4 is removed.

§1.105-6 [Removed]

Par. 4. Section 1.105-6 is removed.

Par. 5. Section 1.106-1 is amended by:

1. Redesignating the existing text as paragraph (a).
2. In newly-designated paragraph (a), revising the first sentence and adding a sentence at the end of the paragraph.
3. Adding paragraph (b).

The revisions and additions read as follows:

§1.106-1 Contributions by employer to accident and health plans.

(a) The gross income of an employee does not include the contributions that the employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse, the employee's dependents (as defined in section 152 determined without regard to section 152(b)(1), (b)(2), or (d)(1)(B)), or any child (as defined in section 152(f)(1)) of the employee who as of the end of the taxable year has not attained age 27. * * * For the treatment of the payment of premiums for accident or health insurance from a qualified trust under section 401(a), see §§1.72-15 and 1.402(a)-1(e).

(b) Effective/applicability date. The first and last sentences of paragraph (a) of this section apply for taxable years beginning on or after January 1, 2015.

Par. 6. Section 1.401-1 is amended by adding a sentence at the end of paragraph (b)(1)(ii) to read as follows:

§1.401-1 Qualified pension, profit-sharing, and stock bonus plans.

* * * * *

(b) * * *

(1) * * *

(ii) * * * See §§1.72-15, 1.72-16, and 1.402(a)-1(e) for rules regarding the tax treatment of incidental life or accident or health insurance.

* * * * *

Par. 7. Section 1.402(a)-1 is amended by:

1. Revising the next to last sentence in paragraph (a)(1)(ii).
2. Removing the last sentence in paragraph (a)(1)(ii).
3. Adding paragraph (e).

The revision and addition read as follows:

§1.402(a)-1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) * * *

(1) * * *

(ii) * * * Paragraph (e) of this section provides rules relating to use of a qualified pension, annuity, profit-sharing, or stock bonus plan to provide accident or health benefits or coverage otherwise described in sections 104, 105, or 106.

* * * * *

(e) Medical, accident, etc. benefits paid from a qualified pension, annuity, profit-sharing, or stock bonus plan--(1) Payment of premiums--(i) General rule. Except as

provided in paragraph (e)(1)(iii) of this section, a payment made from a qualified trust that is a premium for accident or health insurance (including a qualified long-term care insurance contract under section 7702B) constitutes a distribution under section 402(a) to the participant for whose benefit the premium is charged. The amount of the distribution equals the amount of the premium charged against the participant's benefits under the plan. If a defined contribution plan pays these premiums from a current year contribution or forfeiture that has not been allocated to a participant's account, then the amount of the premium for each participant is treated as first being allocated to the participant and then charged against the participant's benefits under the plan, so that the amount of the distribution is treated in the same manner as determined under the preceding sentence. Except as provided in paragraphs (e)(2) and (e)(3) of this section, a distribution described in this paragraph (e)(1) is not excludable from gross income.

(ii) Treatment of amounts received through accident or health insurance. To the extent that the payment of a premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through accident or health insurance are neither paid by the employer nor attributable to contributions by the employer that are excludable from the gross income of the employee. Accordingly, to the extent the premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through the accident or health insurance for personal injuries or sickness are excludable from gross income under section 104(a)(3) and are not treated as distributions from the plan. If those amounts are paid to the plan instead of to the employee, those amounts are treated as having been paid to the

employee and then contributed by the employee to the plan (and must satisfy the qualification requirements applicable to employee contributions).

(iii) Exception for disability insurance that replaces retirement contributions. The rules of paragraph (e)(1)(i) of this section do not apply to the payment made from a qualified trust that is a premium paid to an insurance company for a contract providing for payment of benefits to be made to the trust in the event of an employee's inability to continue employment with the employer due to disability, provided that the payment of benefits with respect to the employee's account for each year does not exceed the reasonable expectation of the annual contributions that would have been made to the plan on the employee's behalf for the period of disability within that year, reduced by any other contributions made on the employee's behalf for the period of disability within that year. The payment of premiums described in the preceding sentence is not treated as a distribution under section 402(a), but instead constitutes incidental accident or health insurance as provided in §1.401-1(b)(1)(ii). The Commissioner may issue rules of general applicability in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin further describing the tax treatment of disability coverage described in this paragraph (e)(1)(iii).

(2) Medical benefits for retired employees provided under an account described in section 401(h). The payment of medical benefits under a pension or annuity plan from an account described in section 401(h) is treated in the same manner as a payment of accident or health benefits attributable to employer contributions, or employer-provided coverage under an accident or health plan. See §1.401-14(a) for the definition of medical benefits described in section 401(h). Accordingly, amounts applied

for the payment of accident or health benefits, or for the payment of accident or health coverage, from a section 401(h) account are not includible in the gross income of the participant on whose behalf such contributions are made to the extent they are excludible from gross income under section 104, 105, or 106.

(3) Distributions to eligible retired public safety officers. See section 402(l) (and any guidance issued under section 402(l)) for a limited exclusion from gross income for distributions used to pay for certain accident or health premiums (including premiums for qualified long-term care insurance contracts). This limited exclusion applies to eligible retired public safety officers, as defined in section 402(l)(4)(B).

(4) Effect of distribution of insurance premiums on plan qualification. See §1.401-1(b)(1) for rules concerning the types and amount of medical coverage and benefits that are permitted to be provided under a plan that is part of a trust described in section 401(a). For example, §1.401-1(b)(1)(ii) provides that a profit-sharing plan is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide incidental accident or health insurance for the participant and the participant's family. See also section 401(k)(2)(B) for certain restrictions on the distribution of elective contributions.

(5) Applicability to beneficiaries and alternate payees. This paragraph (e) applies to the payment of premiums charged against the benefits of a beneficiary or an alternate payee in the same manner as the payment of premiums charged against the account of a participant.

(6) Examples. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) Facts. Employer A sponsors a profit-sharing plan qualified under section 401(a). The plan provides solely for non-elective employer profit-sharing contributions. The plan's trustee enters into a contract with a third-party insurance carrier to provide health insurance for certain plan participants. The insurance contract provides for the payment of medical expenses incurred by those participants. The plan limits the amounts used to provide medical benefits to comply with the incidental benefit rules. The trustee makes monthly payments of \$1,000 to pay the premiums due for Participant P's health insurance and Participant P's account balance is reduced by \$1,000 at the time of each premium payment. In June 2015, Participant P is admitted to the hospital for covered medical care, and in July 2015, the health insurer pays the hospital \$5,000 for the medical care provided to Participant P in June.

(ii) Conclusion. Under paragraph (e)(1) of this section, each of the trustee's payments of \$1,000 constitutes a taxable distribution under section 402(a) to Participant P on the date of each payment. The amount of these distributions may constitute payments for medical care under section 213. The \$5,000 payment to the hospital is excludable from Participant P's gross income under section 104(a)(3) and is not treated as a distribution from the plan.

Example 2. (i) Facts. Employer B sponsors a profit-sharing plan qualified under section 401(a). The plan provides for elective contributions described in section 401(k) and matching contributions as well as non-elective employer profit-sharing contributions. The plan does not provide that a disabled participant's compensation for purposes of determining plan contributions includes amounts that the participant would have received in the absence of the disability, and accordingly Employer B does not make any contributions to the plan for the benefit of a disabled employee for the period of disability. The plan's trustee enters into a contract with a third-party insurance carrier to provide disability insurance for plan participants who elect to be covered under the insurance contract. The insurance contract provides for the payment of an amount to the trustee on a participant's behalf during the period of the participant's disability. Amounts to be paid to the trustee from the insurance contract with respect to a participant are equal to the sum of the elective, matching, and non-elective employer profit-sharing contributions that would have been made on the participant's behalf during the participant's disability (based on the participant's rate of compensation before becoming disabled) with the payments to continue for the duration of the disability until age 65 (or 5 years after the participant became disabled, if later). Participant Q elects to be covered under the insurance contract, and the trustee makes the periodic premium payments out of the account balance of Participant Q. In June 2015, Participant Q becomes disabled. During the period Participant Q is absent from employment due to disability, the insurer pays the trust the amount of the elective contributions and non-elective employer profit-sharing contributions that would have been made to the trust with respect to Participant Q had Participant Q not been disabled. The amount of the premiums for the insurance contract satisfies the limitations on incidental benefits under §1.401-1(b)(1)(ii).

(ii) Conclusion. The payment of premiums from the trust is described in paragraph (e)(1)(iii) of this section. Accordingly, none of the premium payments under the contract constitute a distribution under section 402(a) to Participant Q. Further, amounts paid from the insurance contract to the trust also do not constitute a distribution to Participant Q. However, when Participant Q's account balance is distributed from the trust, the distribution will be subject to taxation in the year of distribution in accordance with the rules in section 402.

(7) Effective/applicability date. This paragraph (e) applies for taxable years beginning on or after January 1, 2015.

Par. 8. Section 1.402(c)-2 is amended by redesignating paragraph A-4(j) as paragraph A-4(k) and adding a new paragraph A-4(j) to read as follows:

§1.402(c)-2 Eligible rollover contributions; questions and answers.

* * * * *

A-4: * * *

(j) Distributions of premiums for accident or health insurance under §1.402(a)-1(e)(1)(i). This paragraph A-4(j) applies for taxable years beginning on or after January 1, 2015.

* * * * *

Par. 9. Section 1.403(a)-1 is amended by revising paragraph (g) to read as follows:

§1.403(a)-1 Taxability of beneficiary under a qualified annuity plan.

* * * * *

(g) The rules of §1.402(a)-1(e) apply for purposes of determining the treatment of

amounts paid to provide accident and health insurance benefits.

Par. 10. Section 1.403(b)-6 is amended in paragraph (g) by adding two sentences at the end of the paragraph to read as follows:

§1.403(b)-6 Timing of distributions and benefits.

* * * * *

(g) * * * The rules of §1.402(a)-1(e) apply for purposes of determining when certain incidental benefits are treated as distributed and included in gross income. See §§1.72-15 and 1.72-16.

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John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: May 6, 2014

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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