DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–148393–06]

RIN 1545–BG12

Medical and Accident Insurance
Benefits Under Qualified Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 402(a) of the Internal Revenue Code (Code) regarding the tax treatment of payments by qualified plans for medical or accident insurance. These regulations would affect administrators of, participants in, and beneficiaries of qualified retirement plans. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 19, 2007. Outlines of topics to be discussed at the public hearing scheduled for December 6, 2007, at 10 a.m., must be received by November 15, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–148393–06), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–148393–06), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or send electronically via the Federal eRulemaking Portal at http://www.regulations.gov (IRS REG–148393–06). The public hearing will be held in
the IRS Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:
Concerning the proposed regulations, Pamela R. Kinard (202) 622–6060; concerning submissions of comments, the hearing, Kelly Banks, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 402(a) of the Code, as well as conforming amendments under sections 72, 105, 106, 401, 402(c), 403(a), and 46422 Federal Register.

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 such 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 such amounts (1) are attributable to contributions by the employer which 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 such amounts are paid, directed or indirectly, to the taxpayer for the payment of expenses incurred by the taxpayer for the medical care of the taxpayer and his or her spouse or dependents.

Section 106 provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106–1 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 a separate trust or fund) for personal injuries or sickness to the employee or the employee’s spouse or dependents.

Section 7702B(a)(1) provides that, for purposes of the Code, a qualified long-term care insurance contract is treated as an accident and health insurance contract.

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, his or her spouse, and dependents, to the extent that the expenses exceed 7.5 percent of the taxpayer’s adjusted gross income. 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 must be satisfied.

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 402(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) 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), added by section 845(a) of the Pension Protection Act of 2006, Public Law 199–280 (120 Stat. 780) (PPA ’06), provides a limited exclusion from gross income for distributions from a qualified 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) shall not exceed $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 includible 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)),.1 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)). See § 1.401(a)–1(b)(1)(ii).

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

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1 Section 1.72–15(d) also refers to benefits excludible under section 105(c) (relating to certain payments unrelated to absence from work) or 105(d), which was repealed in 1983 (and which related to certain disability payments).
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) of this chapter, 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 terms of the plan, 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 concludes that such insurance is treated as incidental if the amount expended does not exceed 25 percent of the funds allocated to a participant’s account that have not been accumulated for the period prescribed by the plan for the deferral of distributions. The ruling also concludes that the use of profit-sharing plan funds to pay for 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) of this chapter, 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), see § 601.601(d)(2) of this chapter, concludes that amounts distributed from a qualified retirement plan under section 1(b)(1)(iv) may be used to provide for insurance premiums on behalf of eligible retired public safety officers and their spouses or dependents. The existence of narrow exceptions for retiree medical benefits under section 401(h) and for distributions for the payment of premiums on behalf of eligible retired public safety officers under section 402(l) is consistent with a general rule for inclusion in gross income of the payments of premiums for accident and health insurance.

Section 402(a) provides that amounts actually distributed from a qualified plan are generally taxable to the distributee in the year of the distribution. There is no general exception in section 402 for a distribution in the form of accident or health insurance.

The proposed regulations would 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 would 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.

The general rule that accident and health insurance premiums are taxable distributions would not apply to amounts held under a medical account that satisfies all the requirements of section 401(h). Accident or health insurance purchased through a section 401(h) account does not constitute a taxable distribution. See § 1.72–15(h), providing that employer contributions to provide medical benefits in section 401(h) under a qualified plan or annuity are not includible in the gross income of the employee on whose behalf contributions were made. The result is the same if the section 401(h) account is funded with a transfer from a qualified pension plan in accordance with section 420. Similarly, section 402(l), as added by PPA ‘06, permits 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. The existence of narrow exceptions for retiree medical benefits under section 401(h) and for distributions for the payment of premiums on behalf of eligible retired public safety officers under section 402(l) is consistent with a general rule for inclusion in gross income of the payments of premiums for accident and health insurance.

Section 402(a) provides that amounts actually distributed from a qualified plan are generally taxable to the distributee in the year of the distribution. There is no general exception in section 402 for a distribution in the form of accident or health insurance. Moreover, Congress

2 See also H.R. Rep. No. 2317, 87th Cong., 2nd Sess., at 4 (1962), stating that no part of the contributions paid by the employer to a section 401(h) account will be taxed currently to the employee.

3 See, for example, the Joint Committee on Taxation’s Technical Explanation, Technical Explanation of H.R. 4, the “Pension Protection Act of 2006” as passed by the House on July 28, 2006, and Considered by the Senate on August 3, 2006 [JCX–38–06], August 3, 2006, 99th Cong., 2nd Sess. 244 (2006), relating to the exception under section 402(l), which states that, under present law, distributions from a qualified plan are generally
has carefully prescribed and strictly limited the ability to pre-fund accident and health insurance benefits on a tax-favored basis. The rules specifically prescribed by Congress relating to the pre-funding of future health benefits on a tax-favored basis include the rules in section 223 (providing contribution limits and distribution rules for health savings accounts (HSAs)); sections 419 and 419A (limiting employer deductions for contributions to welfare benefit funds); section 501(c)(9) (providing requirements for tax-exempt Voluntary Employee Beneficiary Associations (VEBAs)); section 512 (providing for the taxation of a Veba’s unrelated business income); and by sections 401(h) and 420 (governing retiree health benefits provided through a separate health benefits account that is part of a pension or annuity plan). Therefore, because Congress specifically prescribed these limited provisions for favorable tax-treatment, a broad exclusion permitting tax-favored treatment of any distribution used to pay accident or health insurance premiums would be inconsistent with this intentional statutory scheme.

In addition, the existence of the incidental benefit rule in §1.401–1(b)(1)(ii) is not an indication that distributions used to provide accidental life or accident or health insurance benefits are eligible for tax-favorable treatment because the incidental benefit rule relates solely to the qualification of a profit-sharing plan, not to the tax-treatment of amounts used to provide medical or accident insurance benefits under such plan.

The proposed regulations also contain conforming amendments to the Income Tax Regulations under sections 72, 105, 106, 401, and 402(c). These conforming amendments would remove obsolete provisions, as well as cite to the rules in these proposed regulations for determining the tax treatment of the payment of premiums for accident and health insurance from a qualified plan. Conforming amendments under sections 403(a) and 403(b) would also add a cross-reference to the regulations under section 403(a) and section 403(b) that would apply the rules in these proposed regulations to those arrangements. In addition, the proposed regulations would revise the first sentence of §1.106–1 in order to update the definition of dependent in light of section 207 of the Working Families Tax Relief Act of 2004, Public Lic 108–311 (118 Stat. 1166) and Notice 2004–79 (2004–2 CB 898), see §601.601(d)(2). The proposed regulations would also 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 contributions. Finally, these proposed regulations would also include a cross-reference to section 402(l), as added by PPA ’06. For additional guidance on section 402(l), see Notice 2007–7 (2007–5 IRB 395), see §601.601(d)(2).

Proposed Effective Date

It is expected that the regulations will apply for calendar years after the publication of final regulations in the Federal Register. However, no inference should be drawn that the payment of premiums from a qualified plan does not constitute a taxable distribution if made prior to the effective date of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is 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, this proposed regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 6, 2007, beginning at 10 a.m. in the Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by November 19, 2007 and an outline of the topics to be discussed and the amount of time to be devoted to each topic (a signed original and eight (8) copies) by November 15, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Pamela R. Kinard and Michael P. Brewer, 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.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—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 paragraphs (d), (h), and (i).
2. Removing and reserving paragraph (f).

The revisions read as follows:

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

(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 such amounts are excludable from gross income under section 105(b) or (c) and the regulations thereunder.
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 shall 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 such 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 revising the first sentence and adding a new sentence at the end of the paragraph to read as follows:

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

The gross income of an employee does not include the contributions which 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, or the employee’s dependents (as defined in section 152 determined without regard to section 152(b)(1), (b)(2), or (d)(1)(B)).

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).

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

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

(a)(i) * * * * * * * *

(b)(i) * * * 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 removing the last two sentences of paragraph (a)(1)(iii) and adding a new sentence in their place and by adding a new paragraph (e) to read as follows:

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

(a) * * * * *

(1) * * *

(i) * * *

(ii) * * *

(e) Medical, accident, etc. benefits paid from a qualified pension, annuity, profit sharing, or stock bonus plan—(1) Payment of premiums—(i) General rule. The payment of premiums from a qualified trust 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 against 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 will be 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 described in paragraphs (e)(2) and (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 premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through accident or health insurance are neither attributable to contributions by the employer which are not includible in the gross income of the employee nor are such amounts paid by the employer. Accordingly, 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 amounts received through accident or health insurance are paid to the plan instead of the employee, these amounts are treated as having been paid to the employee and then contributed by the employee to the plan (and these amounts must satisfy the qualification requirements applicable to employee contributions).

(2) Medical benefits for retired employees provided under an account described in section 401(h). The payment of medical benefits described in section 401(h) under a pension or annuity plan 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) 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 making a distribution of insurance premiums on 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) Application of this paragraph (e).

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) Example. The provisions of this paragraph (e) are illustrated by the following example:
Example. (i) Facts. Employer 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 policy provides for the payment of medical expenses incurred by those participants. The plan limits the amounts used to provide medical benefits with respect to a participant to 25 percent of the funds held in the participant’s account. The trustee makes monthly payments of $1,000 to pay the premiums due for Participant A’s health insurance. The trustee also reduces Participant A’s account balance by $1,000 at the time of each premium payment. In June of a year, Participant A is admitted to the hospital for covered medical care, and in July of the same year, the health insurer pays the hospital $5,000 for the medical care provided to Participant A in June.

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

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

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

  A–4: * * *
  (h) Distributions of premiums for accident or health insurance under § 1.402(a)–1(e).
* * * * *

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 by adding a sentence following the first sentence of paragraph (g) to read as follows:

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

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

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Linda E. Stiff, Acting Deputy Commissioner for Services and Enforcement.

[FR Doc. E7–16084 Filed 8–17–07; 8:45 am]

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