



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

NOV 15 2007

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

U.I.L 402.00-00

\*\*\*\*\*  
\*\*\*\*\*  
\*\*\*\*\*  
\*\*\*\*\*

Attention: \*\*\*\*\*

Legend:

- Company M = \*\*\*\*\*
- Plan X = \*\*\*\*\*
- Trustee C = \*\*\*\*\*
- Policy B = \*\*\*\*\*
- Company S = \*\*\*\*\*
- State H = \*\*\*\*\*

Dear

This is in response to your request dated July 11, 2001, submitted on your behalf by your authorized representative concerning the federal income tax consequences under sections 401, 402, 105, and 7702B of the Internal Revenue Code (the "Code") of certain contributions made by the participants in Plan X to purchase long-term care insurance. Your ruling request has been supplemented by information received from your authorized representative dated November 25, 2002, August 2, 2005, September 29, 2005, and October 11, 2007.

The following facts and representations have been submitted on your behalf:

\*\*\*\*\*

Company M sponsors Plan X for the benefit of its employees and the employees of certain affiliate employers. Plan X, which is described as a profit-sharing plan qualified under section 401(a), was adopted on February 1, , and amended and restated on February 12, , effective as of January 1, , and includes a cash or deferred arrangement as described in section 401(k) of the Code.

Company M and the affiliate employers who have adopted Plan X make non-elective profit-sharing contributions to Plan X under section 4.1(c) and matching employer contributions under section 4.1(b). Plan X participants make employee elective contributions under section 4.2 of Plan X. Qualified non-elective contributions are made to Plan X pursuant to the terms of section 4.6.

Company M proposes to make available to Plan X participants the option to acquire long-term care insurance. Such insurance would be available to a Plan X participant and his or her spouse and dependents. Company M proposes that the benefits received from the long-term insurance by the Plan X participant and his or her spouse and dependents would be excludable from income under Code section 105(b) (subject to the limits of Code section 7702B) as amounts received for personal injury or sickness under a health and accident plan.

Section 4.10 of Plan X permits the administrator of Plan X (Company M) to determine, in its sole discretion that all Plan X participants be permitted to direct Trustee C as to the investment of all or a portion of the interest in their Elective Accounts. You represent that Plan X will be amended to permit all Plan X participants to direct Trustee C as to the investment of all of a portion of the amounts allocated to their Employer Non-Elective Contribution Accounts.

Company M and the affiliate employers who have adopted Plan X make non-elective profit-sharing contributions to Plan X under section 4.1(c) and matching employer contributions under section 4.1(b). Plan X participants make employee salary reduction elective contributions under section 4.2 of Plan X. Employer qualified non-elective contributions are made to Plan X pursuant to the terms of section 4.6. All amounts contributed on behalf of a participant are held in the participant's "Elective Account", although separate accounting is maintained with respect to that portion of such account attributable to the participant's salary reduction elective contributions, Employer matching contributions, and any Employer Qualified Non-Elective Contributions.

Section 4.2 of Plan X provides that the balance in each participant's Elective Account, as described above, shall be fully vested and shall not be subject to forfeiture, except for certain adjustments for excess contributions. Section 4.2 further provides the restrictions on amounts held in the participant's Elective Account as required by section 401(k)(2)(B) of the Code.

To accomplish the direction by the participant of all of a portion his or her Participant Elective Contribution Account or the Employer Non-Elective

Contribution Account, Company M proposes to amend Plan X to, among other things,

- (a) allow a Plan X participant to elect to direct Trustee C to acquire long-term care insurance coverage for the participant, his or her spouse and dependents with the contributions and earnings thereon, through
  - (i) a Participant's Elective Contribution Account, or
  - (ii) a Participant's self-directed Employer Non-Elective Contribution Account, or
- (b) following such election, terminate long-term care insurance coverage,
- (c) limit the amount that may be expended from a Participant's accounts under Plan X for accident and health insurance and other incidental benefits to
  - (i) twenty-five (25%) percent of the amount in such Participant's accounts that has not been accumulated by Plan X for the period for deferment of distribution, or
  - (ii) one hundred (100%) percent of the amount in such Participant's accounts that has been accumulated by Plan X for the period of deferment of distributions,
- (d) allow in-service distributions of all vested amounts in a Participant's Employer Non-Elective Contribution Accounts to Participants who have reached age fifty-five (55) and completed at least five (5) years of participation in Plan X, and
- (e) allow in-service distributions of a Policy or benefits of a Policy purchased by Plan X from either Participant Elective Contribution Accounts or Employer Non-Elective Contribution Accounts in the event that a Participant, his or her spouse, or dependents have incurred or is reasonably (as determined by the Administrator pursuant to uniform rules consistently applied) certain to incur long-term care expenses which qualify as hardship, provided such distribution does not exceed the value of the participant's vested interest in such Account.

Company M proposes to use Policy B that will be the individual policy providing for long-term care insurance sponsored by Company S, a life insurance company under the jurisdiction of State H. However, Plan X proposes to allow other long-term care insurance policies to be acquired so long as any long-term care insurance policy acquired by Plan X is a "qualified long-term care insurance contract" as provided in Code section 7702B. Trustee C of Plan X will be the

purchaser and policyholder of Policy B, and not the individual Plan X participant, but amounts will be deducted periodically from the appropriate Participant Account of those participants electing long-term care insurance coverage to pay the premiums on Policy B. Policy B will be required to pay benefits directly to Plan X. A Plan X participant will not be allowed to assign his or her benefits under Policy B so long as it is held by Plan X. Policy B will be canceled by Trustee C as the policyholder upon written direction of the participant. Upon the occurrence of an event stipulated in Plan X permitting distribution of Plan X benefits, Policy B, at the election of a participant, may be surrendered by Trustee C, distributed in kind to the participant, or rolled over to an individual retirement arrangement (IRA) established by the participant or the participant's spouse.

You represent that there is no assignment of benefits under a long-term care insurance policy. Before reimbursement will be made to a participant for long-term care expenses, evidence of qualifying expenses under the tax-qualified long-term care policy must be submitted to the insurance company. You also state that the person providing services for which reimbursement is sought must be a certified provider under the terms of the policy. The long term care benefits then would be paid out of Plan X directly to the participant for payment or reimbursement of the expense.

Based on the foregoing facts and representations, the following rulings are requested:

1. Participants who elect to have long-term care insurance benefits under Plan X for themselves, spouse, and dependents will not be currently taxable on the cost of the long-term care insurance coverage.
2. Acquisition by Plan X of a long-term care insurance policy (Policy B) will be a permitted incidental benefit.
3. Amounts received by Plan X from Policy B are not annual additions to Plan X subject to the limits of section 415(c) of the Code.
4. Long-term care insurance benefits (other than policyholder dividends as defined in section 808 of the Code and premium refunds) (i) received by a participant on behalf of the participant or his or her spouse or dependents from Policy B proceeds received by Plan X prior to the participant terminating employment, or (ii) received directly by a participant who takes an in kind distribution of Policy B from Plan X (upon the occurrence of an event under Plan X permitting distribution of Plan X benefits) on behalf of the participant, his or her spouse,

or dependents, will be excludable from the income of the participant when received as amounts received from accident, or health insurance for personal injury or sickness under section 105(b) of the Code, subject to the limits of section 7702B of the Code.

5. Plan X may permit in-service distributions of all vested amounts in the Employer Non-elective Contribution Accounts to participants who have reached fifty-five (55) years of age and have completed at least five (5) years of participation in Plan X.
6. Plan X may permit in-service distributions of long-term care benefits or a policy from a Participant Elective Contribution Account or an Employer Non-Elective Contribution Account due to hardship in the event that a participant, his or her spouse, or dependents has incurred or is reasonable expected (as determined by the Administrator pursuant to uniform rules consistently applied) to incur long-term care expenses, provided such distribution does not exceed the value of the participant's vested interest in such Account.
7. Upon the occurrence of an event under Plan X permitting distribution of Plan X benefits (including an in-service distribution), any policy acquired by Plan X may be distributed to the participant in kind. If the participant does not elect to roll over the policy to an individual retirement arrangement, the value of the policy to be included in the income of the participant will be equal to the unearned premiums on the policy on the date of distribution.
8. Any Policy acquired by Plan X may be rolled over tax-free to an individual retirement arrangement established by the participant, or if the participant has died, the participant's spouse, provided that the transfer is an eligible rollover distribution within section 402(c)(4) of the Code.
9. Long-term care insurance benefits paid to the participant on behalf of the participant, his or her spouse, or dependents from policy proceeds received by an individual retirement arrangement into which the participant transferred the policy from Plan X will be excludable from the income of the participant when received for personal injury or sickness under section 105(b) of the Code, subject to the limits of section 7702B of the Code.

Section 402(a) provides that any amount actually distributed to any distributee by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 of the Code (relating to annuities).

Section 1.402(a)-1(a) of the Income Tax Regulations (the "regulations") provides that if an employer makes a contribution for the benefit of any employee to a qualified plan, the employee is not required to include such contribution in his gross income until the year or years in which such contribution is distributed or made available to him.

Revenue Ruling 61-164, 1961-2 C.B. 99 provides that a profit-sharing plan does not violate the incidental benefit rule in section 1.401(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 the major medical benefits for the participant under the group hospitalization insurance for the employer's employees, provided that the total amount used for life or accident insurance for his and his family is incidental. The revenue ruling further provides that such insurance will be treated as incidental if, in the aggregate, the amount expended for such benefits 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 deferment of distributions. However, Revenue Ruling 61-164 provides that the incidental benefit requirement does not limit the amount expended for such benefits from funds allocated to a participant's account that have been accumulated for the period prescribed by the plan for the deferment of distributions. The revenue ruling also concludes that although the purchase of the major hospitalization insurance does not prevent the qualification of the plan if the insurance is deemed to be "incidental", the use of the funds to pay for the employees' medical insurance is a distribution within the meaning of section 402 of the Code.

Proposed income tax regulations under section 402 (the "Proposed Regulations") were published in the Federal Register on August 20, 2007, that clarify that a payment from a qualified plan for an accident or health insurance premium generally constitutes a distribution under Code section 402(a) that is taxable to the distributee under section 72 in the taxable year in which the premium is paid. It is expected that these regulations will apply for calendar years after the publication of final regulations, 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. Section 1.402(a)-1(ii)(e)(1)(i) of the Proposed Regulations provides that 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) (medical benefits for retired employees provided under an account described in section 401(h)) and (3) (distributions to eligible retired public safety officers) of this section, a distribution described in this paragraph (e)(1) is not excludable from gross income.

Section 1.402(a)-1(ii)(e)(1)(ii) of the Proposed Regulations provides that to the extent that the premium for accident or health insurance constitutes a distribution under (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) of the Code 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 contributed by the employee to the plan (and these amounts must satisfy the qualification requirements applicable to employee contributions).

Section 1.402(a)-1(ii)(e)(4) of the Proposed Regulations describes the effect of making a distribution of insurance premiums on plan qualification. Section 1.401-1(b)(1) of the regulations contains the 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) of the Code. For example, section 1.401-1(b)(1)(ii) of the regulations provides that a profit sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. The regulation also provides that a profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance. Section 1.402(a)-1(ii)(e)(4) also provides that section 401(k)(2)(B) of the Code contains the restrictions on the distribution of elective deferrals and the effect such a distribution to pay insurance premiums has on plan qualification.

Section 401(k)(2)(B) of the Code provides, in general, that a participant's elective deferrals, qualified nonelective contributions, and qualified matching contributions and income allocable to each may not be distributed earlier than upon the participant's severance from employment, death, or disability; an event described in section 401(k)(10) (distributions upon plan termination); in the case of a profit-sharing or stock bonus plan, the attainment of age 59 ½; in the case of contributions to a profit-sharing or stock bonus plan to which section 402(e)(3) applies, upon hardship of the employee, or in the case of a qualified reservist distribution (as defined in section 72(t)(2)(G)(iii)), the date on which a period referred to in subclause (III) of such section begins, and will not be distributable merely by reason of the completion of a stated period of participation or the lapse of a fixed number of years.

In this case, Company M proposes to amend Plan X to allow a participant to elect to direct Trustee C acquire long-term care insurance coverage for the participant, his or her spouse and dependents. The premiums for the long-term care insurance provided under Policy B will be periodically deducted from the Elective Contribution Account or the self-directed Employer Non-Elective Contribution Account of the participant who elects such coverage. Pursuant to Revenue Ruling 61-164, the use of the above accounts, in this case, to pay the premiums for the long-term care insurance is treated as a distribution within the meaning of section 402 of the Code to the participant from Plan X at the time such amount is used to pay the premiums. Accordingly, with respect to ruling request number one, we conclude that a participant who elects to have long-term care insurance benefits under Plan X for himself or herself, their spouse, and dependents as proposed by Company M will be currently taxable on the cost of the long-term care insurance coverage under section 402(a) of the Code.

The amounts Company M proposes to allow participants to use to pay the premiums to acquire the long-term insurance coverage are amounts allocated to a participant's Elective Contribution Account and/or the participant's Employer Non-Elective Contribution Account, amounts which are made to Plan X pursuant to section 401(k)(2)(A) of the Code, and which therefore are subject to the restrictions on distributions in section 401(k)(2)(B). A distribution of insurance premiums in this case would cause Plan X to fail to comply with section 401(k)(2)(B) and section 401(a) of the Code.

Ruling requests number two through number nine concern, in general, the acquisition of Policy B as a permitted incidental benefit, whether the benefits received by a participant from Policy B are annual additions, whether the benefits received by a participant from Policy B are excludable from gross income under section 105(b) of the Code, whether Plan X may permit certain in-service distributions of Policy B, and whether Policy B may be rolled over to an individual retirement arrangement. These rulings are considered moot in as much as we have concluded that the payment of premiums for the long-term insurance coverage from the participant's Elective Contribution Account and/or the



participant's Employer Non-Elective Contribution Account is a distribution under Code section 402(a) in the year in which such account is charged for the cost of the coverage, and that the distribution of insurance premiums to pay the cost of such coverage adversely affects the continued qualified status of Plan X under Code section 401(a).

This ruling is directly only to the taxpayer that requested it. Code section 6110(k)(3) provides that it may not be used or cited by others as precedent.

A copy of this ruling is being sent to your authorized representative pursuant to a Power of Attorney (Form 2848) on file in this office.

If you have any questions about this ruling, please contact me at  
\*\*\*\*\*SE:T:EP:RA:T:2.

Sincerely yours,

**(signed) JOYCE E. FLOYD**

Joyce E. Floyd, Manager  
Employee Plans Technical Group 2

Enclosures:

Deleted Copy of this ruling  
Notice of Intention to Disclose