



AMERICAN BENEFITS COUNCIL

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SUMMARY OF PROPOSED REGULATIONS ON ACCIDENT OR HEALTH INSURANCE UNDER A QUALIFIED PLAN

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The Treasury Department released proposed regulations on the tax treatment of long-term care (LTC) insurance, health insurance and disability insurance held by a 401(k) plan or other tax-qualified retirement plan.

In general, the proposed regulations provide that a premium charged against a participant's benefit in a plan for insurance covering the participant (such as a health insurance premium debited from a participant's account in a 401(k) plan) is treated as a taxable distribution from the plan. To the extent the premium is includible in income, the proposed regulations provide that benefits paid from the insurance would generally be excludable from income.

The purchase of insurance would continue to be subject to the incidental benefit requirements. It appears that a premium payment would also be considered a distribution subject to the limitations on in-service distributions from a tax-qualified retirement plan, but this does not seem entirely consistent with prior guidance on incidental benefits. It also appears that premium payments may be subject to the 10 percent addition to tax under section 72(t). It is not clear whether taxable distributions attributable to such insurance would give rise to basis in the plan (as imputed income on life insurance coverage does).

The proposed regulations provide limited exceptions from the general rule that premium payments would be considered taxable distributions, including exceptions for premiums paid from 401(h) accounts in pension plans and for limited health or LTC premium payments (up to \$3,000 annually) made on behalf of eligible retired public safety officers (which was added to the Code by the Pension Protection Act of 2006 (PPA)).

The proposed regulations also address the tax treatment of accident or health insurance that is held as an investment by a plan, rather than as a benefit providing current coverage to a participant. In this regard, for example, some 401(k) plans allow participants to use their account balances to purchase disability insurance benefits that replace anticipated retirement plan contributions in the event of disability. The IRS has issued a number of private letter rulings indicating that such a plan investment is not treated as a taxable distribution. The proposed regulations, however, would appear to reverse the position reflected in the PLRs and provide that premium payments for the disability insurance investment are taxable distributions. In addition, the proposed regulations indicate that the receipt of insurance proceeds by the plan would be treated as a payment to the participant followed by a contribution to the plan, subject to all applicable requirements including the section 415 limit on total annual contributions. These rules would make it very difficult for plans to offer these insurance investment options. The regulations, however, specifically request comment on this aspect of the rules.

The proposed regulations would be generally effective for calendar years beginning after the date the final regulations are published. However, the proposed regulations also state that no inference should be drawn from the regulations that the payment of premiums from a qualified plan is not a taxable distribution if made in prior years.