



IRS issues final rules on tax treatment of medical or health insurance payments from qualified plans

On May 12, 2014, the IRS issued final regulations that clarify the tax treatment of payments for accident or health insurance by qualified retirement plans. The final rules provide that amounts held in a qualified retirement plan used to pay accident or health insurance premiums are taxable distributions unless there is an exception. The final regulations include an additional exception, to already existing exceptions, under which payment of disability insurance premiums from a qualified plan are not taxable if certain requirements are satisfied.

Background

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 dependents, provided certain conditions are satisfied. For example, a separate account must be established and maintained for these benefits, and an employer's contribution to this separate account must be reasonable and ascertainable.

In addition, any amount distributed by a qualified plan is taxable in the year distributed, unless there is an exception. In general, payments for accident or health benefits that are attributable to employer contributions are includible in gross income.

Final rules

The final rules clarify that a payment from a qualified plan attributable to employer contributions for accident or health insurance premiums, including a qualified long-term insurance contract, is a distribution that is taxable in the 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. The rules confirm that this tax applies to participants, their spouses and dependents, beneficiaries or an alternate payee covered under a qualified domestic relations order. The final regulations also clarify that an employee's dependent includes children who have not attained age 27 as of the end of the taxable year.

If a defined contribution plan pays these premiums in a current year contribution or forfeiture that has not been allocated to the participant's account, 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. The payment of an accident or health plan premium from unallocated contributions or forfeitures is considered a distribution to the participant that is taxable in the year in which the premium is paid.

Exceptions

The payment of an accident or health insurance premium from a qualified plan is a taxable distribution unless one of the following exceptions applies:

- **Distributions to eligible retired public safety officers.** Eligible retired public safety officers may receive tax-free distributions from qualified retirement plans for the payment of qualified health insurance premiums. The maximum annual amount of these tax-free distributions is \$3,000. To qualify for the special tax treatment, the premium payments must be made directly from the retirement plan to the insurer. Premiums may be for accident or health insurance or for long term care insurance for the retired public safety officer, his spouse or his dependents.

- **Medical benefits for retired employees under an IRC section 401(h) account.** Amounts payable from an IRC section 401(h) account attributable to employer contributions for the payment of sickness, hospitalization and medical benefits for retired employees, their spouses and dependents are excluded from gross income.
- **Disability insurance that replaces retirement contributions.** The final regulations provide a new exception. The payment of disability insurance premiums from a qualified plan or from an annuity or account under IRC sections 403(a) or 403(b) is treated as a plan investment provided the:
 - Insurance contract provides for the payment of benefits to be made to the plan's trust;
 - Employee can no longer continue to work due to disability; and
 - Payment of benefits to the employee's account does not exceed the reasonable expectation of the annual contribution made to the plan on behalf of the employee during the period of disability reduced by any other contributions made on the employee's behalf for the period of disability.

The IRS provides an example that payment of benefits with respect to an employee's account may increase to reflect reasonably expected future salary increases. However, if the insurance provides for payments that exceed the reasonable expectation of the annual contribution that would have been made to the plan on the employee's behalf during the period of disability, then this exception for disability coverage does not apply and *all* of the premium payments would be treated as taxable distributions.

The Treasury Department and 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 treated as a return on a plan investment. Instead, the amounts paid from the insurance contract to the plan are treated as contributions to the plan and are subject to the rules that apply to qualified plan contributions, including the maximum annual additions limit under IRC 415(c).

In addition, to the extent the employer self-insures the disability coverage, the amounts paid to the plan would be considered a contribution to the plan and subject to the plan contribution limits under IRC section 415(c) rules.

Effective date and next steps

The final rules are effective May 12, 2014 and apply for taxable years that begin on or after January 1, 2015, but taxpayers may elect to apply the rules to earlier taxable years. Plan sponsors should carefully read the guidance discussed in this publication and contact their legal counsel if they have any questions about this recent guidance.

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