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

200235043

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue Nos.
401.29-00 **106.00-00**
105.00-00
72.00-00

PERSON TO CONTACT

TELEPHONE NUMBER

OFFICE SYMBOLS
T:EP:RA:T1

Attn:,

JUN 6 2002

Legend:

Company A =

Division X =
Benefit Y =

Dear Sirs and Madams:

This is in response to your request dated September 1, 1999, as supplemented by correspondence dated June 11, 2001, for a letter ruling on the proper treatment of Benefit Y, described below, under sections 105, 106, 401(a)(2), 401(a)(17), 401(a)(30), 401(k)(3), 401(k)(4)(A), 401(m)(2), 402(a), 402(g), 404(a)(3) and 415(c) of the Internal Revenue Code ("Code").

The principal business of Company A is the sale of life insurance, accident and health insurance, annuity contracts, prototype and specimen plan documents, and recordkeeping services for pension, profit sharing, and other retirement plans, among other products, to individuals and institutions.

Division X is a division of Company A that markets group disability products. Division X proposes to offer Benefit Y which will be issued to and owned by a qualified defined contribution plan that includes a cash or deferred arrangement ("CODA") as described in section 401(k)(2) of the Code ("401(k) plan"), or the employer maintaining such a qualified plan, to be held by the employer for the benefit of the plan.

The purpose of Benefit Y is to permit employees who are disabled to continue to save for retirement. Benefit Y is designed to replace the elective deferrals, matching contributions and any nonelective contributions that would have been credited to a participant's account under a 401(k) plan had the participant not become disabled. Benefit Y will cover only employees who are eligible to participate in the employer's 401(k) plan and who make elective deferrals.

The premium for Benefit Y will be an administrative charge against all enrolled participants' accounts (including elective deferrals). Generally, upon disability, Benefit Y will pay benefits annually to the disabled participant's account under the 401(k) plan in an amount equal to the sum of the amount of elective deferrals, matching contributions and/or profit-sharing or other nonelective contributions made on behalf of such participant to the 401(k) plan in the year immediately preceding the year in which such participant became disabled. If, however, upon disability, a participant had his or her elective deferrals suspended, such as by receiving a hardship withdrawal or having made elective contributions that exceed qualification limitations, Benefit Y would be based on the annualized rate of elective contributions and matching contributions made during the twenty-four month period preceding the date of disability.

If, however, an employee was not eligible to participate in the 401(k) plan, was eligible but had elected not to make elective deferrals under the plan or his or her participation in the plan was voluntarily suspended on the day immediately preceding the date on which he or she became disabled, such individual would not be eligible for Benefit Y.

Payment of proceeds from Benefit Y commence upon completion of any required elimination period after disability and continue until the earliest of (i) the month in which the participant attains age 65 (if the participant becomes disabled before attaining age 60), (ii) a period ranging from three months to forty-eight months (if the participant becomes disabled after attaining age 60, depending upon the participant's age when disability occurs), (iii) the participant's recovery from the disability, (iv) the participant's death, (v) the expiration of a period specified in the contract for disabilities due to certain medical conditions specified in the disability policy; or (vi) the participant's failure to satisfy certain conditions such as the failure to provide requested medical information or to participate in a prescribed rehabilitation program. All Benefit Y payments will be nonforfeitable when paid.

Based on the above facts and representations, Company A requests the following rulings:

(1) Benefit Y, when purchased by a 401(k) plan, will constitute an incidental accident and health insurance benefit, within the meaning of section 1.401-1(b)(1)(ii) of the Income Tax Regulations;

(2) Benefit Y, when provided to employees in the manner described in this request, will not be considered an "other benefit" which is conditioned (directly or

indirectly) on the employee electing to have the employer make or not make elective deferrals under the 401(k) plan, within the meaning of section 401(k)(4)(A) of the Code and section 1.401(k)-1(e)(6) of the regulations;

(3) The continued participation of the disabled employee in the 401(k) plan, through the payment of elective deferrals, matching contributions and/or any nonelective contributions by Benefit Y does not violate the exclusive benefit rule of section 401(a)(2) of the Code;

(4) The limitations of sections 401(a)(17), 401(a)(30), 401(k)(3), 401(m)(2), 402(g), 404(a)(3) and 415(c) of the Code apply only at the time the premiums for Benefit Y are paid and not as benefits under Benefit Y are allocated to the disabled participant's account under the plan;

(5) To the extent that premiums under Benefit Y are paid by employer contributions (including elective deferrals), an employee's coverage under Benefit Y will be considered employer-provided coverage under an accident and health plan, which will be excludable from the employee's gross income under section 106 of the Code and section 1.106-1 of the regulations;

(6) The payment of premiums under Benefit Y will not be considered an assignment of income, which would otherwise result in immediate taxation to the participant;

(7) Benefit payments under Benefit Y to the disabled participant's account under the 401(k) plan will be tax deferred and not includible in the affected participant's gross income under section 105(a) of the Code at the time they are allocated to such participant's account; and

(8) The distribution of amounts from the participant's account under the 401(k) plan (including Benefit Y payments allocated to such account) shall be subject to taxation under the principles of sections 72 and 402 of the Code.

With regard to ruling request one, section 1.401-1(b)(5) of the regulations states, in part, that "no specific limitations are provided in section 401(a) of the Code with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law."

Section 1.401-1(b)(1)(ii) of the regulations provides that a profit-sharing plan within the meaning of Code 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.

Incidental insurance benefits, as described in Revenue Ruling 61-164, 1961-2 C.B. 99, Revenue Ruling 74-307, 1974-2 C.B. 126 and Revenue Ruling 76-353, 1976-2 C.B. 112, have been paid directly to the beneficiary(ies) designated by the plan participant. In this case, the 401(k) plan itself is the designated beneficiary for any payments made from Benefit Y. Because Benefit Y and the proceeds of Benefit Y remain assets of the 401(k) plan, there is no taxable "distribution" within the meaning of section 402 of the Code when Benefit Y is purchased by the plan. Nevertheless, payments from Benefit Y to the plan will result in an increase in the balance in the participant's account just as if the participant had continued to make contributions to the plan. Providing protection to the plan participant from the economic loss that would occur if he or she were unable to continue to make contributions to the plan is a current benefit (although not distributed). Consequently, the payment of premiums under Benefit Y on behalf of a participant is an incidental insurance benefit that is subject to the limitations set forth in the published guidance.

Accordingly, the payment of premiums under Benefit Y on behalf of a participant will constitute an incidental accident and health insurance benefit within the meaning of section 1.401-1(b)(1)(ii) of the regulations, if, on behalf of such participant, the premiums paid under Benefit Y, plus any other incidental insurance benefits, do not exceed the permitted limitations on such benefits.

With respect to ruling request two, section 401(k)(4)(A) of the Code provides that benefits (other than matching contributions) must not be contingent on an employee's election to defer. A CODA of any employer shall not be treated as a qualified CODA if any other benefit is conditioned directly or indirectly on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.

Section 1.401(k)-1(e)(6)(ii) of the regulations includes health insurance and life insurance benefits under the definition of "other benefits." However, section 1.401(k)-1(d)(6)(ii) of the regulations makes it clear that a section 401(k) plan may purchase life insurance with a participant's contributions without violating the contingent benefit rule.

Benefit Y proceeds, like the return on any other plan investment, increase the accumulations in the 401(k) plan that will be payable to the participant or beneficiary when a distributable event, as defined in the plan, actually does occur. Meanwhile the participant generally may not access such proceeds. Benefit Y and any proceeds of Benefit Y remain assets of the plan and no distribution within the meaning of section 402 of the Code results when a portion of a plan participant's elective deferrals are invested in Benefit Y.

We believe the treatment of Benefit Y as a plan investment is consistent with the position that the purchase of Benefit Y coverage does not violate the contingent benefit rule under section 401(k)(4)(A) of the Code.

Accordingly, with respect to ruling request two, we conclude that Benefit Y, when provided to employees in the manner described in this request, will not be considered an "other benefit" which is conditioned (directly or indirectly) on the employee electing to have the employer make or not make elective deferrals under the 401(k) plan, within the meaning of section 401(k)(4)(A) of the Code and section 1.401(k)-1(e)(6) of the regulations.

With regard to ruling request three, section 401(a)(2) of the Code generally provides that in order for a plan to be qualified under Code section 401(a) the corpus or income of its related trust must not be used for, or diverted to, purposes other than the exclusive benefit of the employees or their beneficiaries.

Section 1.401-1(b)(4) of the regulations clarifies Code section 401(a)(2) by providing that a plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave.

In Rev. Rul. 72-180, 1972-1 C.B. 107, a unit benefit pension plan was amended to provide that a participant who became disabled would receive a pension at the normal retirement age, based on compensation for the year immediately preceding the year in which he became disabled, with additional service credits for the entire period of disability up to normal retirement age. The employee thus continued to accrue benefits under the pension plan as if he had remained actively employed with his salary frozen in the year preceding the date of his disability. Rev. Rul. 72-180 stated that section 1.401-1(b)(4) of the regulations permits a qualified plan to provide for continued participation in the event of leave of absence for a specified purpose, such as service in the Armed Forces, sickness or disability. It was held that the provisions made for disability benefits did not adversely affect the continued qualification of the pension plan under section 401(a) of the Code.

Accordingly, with respect to ruling request three, we conclude that the continued participation of the disabled employee in the 401(k) plan, through the payment of elective deferrals, matching contributions and/or any nonelective contributions by Benefit Y does not violate the exclusive benefit rule of section 401(a)(2) of the Code.

With regard to ruling request four, section 401(a)(17) of the Code provides that the annual compensation of each employee taken into account under a qualified plan must not exceed $200,000 (plus the cost-of-living adjustment).

Sections 401(a)(30) and 402(g) of the Code provide limitations on elective deferrals for qualified section 401(k) plans.

Section 401(k)(3) of the code sets forth participation and nondiscrimination standards for qualified section 401(k) plans, including applying percentage tests to the amounts of employer contributions for highly compensated and for nonhighly compensated employees. Section 401(m)(2) of the Code sets forth similar percentage tests for the sums of employee contributions and corresponding matching employer contributions of each participant.

Section 404(a)(3) of the Code sets forth limits for deductibility of employer contributions to qualified stock bonus and profit sharing trusts.

Section 415(c) of the Code sets forth the limitations for contributions and other additions with respect to a participant to a qualified defined contribution plan (such as a section 401(k) plan).

Unlike the contributions paid for premiums for Benefit Y, the proceeds from Benefit Y that are paid to a section 401(k) plan are neither employer contributions nor employee contributions nor forfeitures, but are plan investment earnings.

Accordingly, with respect to ruling request four, we conclude that the limitations of sections 401(a)(17), 401(a)(30), 401(k)(3), 401(m)(2), 402(g), 404(a)(3) and 415(c) of the Code apply only at the time the premiums for Benefit Y are paid and not at the time benefits under Benefit Y are allocated to the disabled participant's account under the plan.

With respect to ruling request five, section 106(a) of the Code provides that 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 gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to the employee for personal injuries or sickness.

Under the regulations, the employer may contribute to an accident or health plan either by paying the premium or by contributing to a separate trust or fund which provides accident or health benefits. However, the trustee of a qualified plan under section 401(a) of the Code is not the employer of the plan participants, so section 106 of the Code does not apply to the facts in this case. Rather, the federal income tax treatment of qualified retirement plans, and specifically, the taxation of qualified plan distributions, is governed by an entirely different statutory arrangement.

In this case, the plan itself is the designated beneficiary for any payments made from Benefit Y. Since Benefit Y and the proceeds of Benefit Y remain assets of the qualified plan, there is no taxable "distribution" within the meaning of section 402 of the Code when Benefit Y is purchased by the plan. Thus, the payment of premiums under Benefit Y will not be includible in the employee's gross income, because they will not be distributions under section 402 of the Code.

Accordingly, with respect to ruling request five, participants in the plan who elect coverage under Benefit Y are not currently taxed on the cost of coverage because the purchase of coverage under Benefit Y does not constitute a distribution under Code section 402.

With respect to ruling request six, in this case, Benefit Y and the proceeds of Benefit Y remain assets of the qualified plan. Accordingly, the payment of premiums under Benefit Y constitutes a purchase of assets by the plan and is neither a gratuitous assignment of income nor an assignment of income for consideration by the electing plan participants.

With regard to ruling request seven, section 105(a) of the Code provides that except as otherwise provided in section 105, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be 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.

In this case, any Benefit Y proceeds that are paid to the 401(k) plan's trust are considered plan earnings. Under the purpose and payment process of Benefit Y, there is no direct payment to the plan participant and no benefit proceeds are made available to the participant. No distributable event occurs at the time at which Benefit Y proceeds are paid to the plan's trust for allocation to a participant's account for the purpose of the continuation of the participant's retirement accumulations during the disability period. Since the proceeds of Benefit Y are received by the plan and not the employee, section 105(a) of the Code does not apply. However, under the rules of section 402 of the Code and the applicable regulations, with regard to Benefit Y, there is no taxation of a plan participant until some amount attributable to proceeds from Benefit Y is distributed or made available to the participant.

Accordingly, with regard to ruling request seven, we conclude that amounts paid under Benefit Y to the disabled participant's account under the qualified plan will not be includible in the participant's gross income at the time such amounts are allocated to the participant's account.

With respect to ruling request eight, subsections (a)-(c)(1) of Code section 72 provide, in general, that a distributee is taxed on the amount received which exceeds the "investment in the contract" and that such "investment in the contract" as of the annuity starting date is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

In general, cash distributions from section 401(k) plans are fully taxable, except for the return of after-tax employee contributions. Pursuant to Code section 72, distributees have basis in qualified plan distributions only when the distributees were previously taxed on the contributions.

Accordingly, with respect to ruling request eight, we conclude that the distribution of amounts from the participant's account under the 401(k) plan (including Benefit Y payments allocated to such account) shall be subject to taxation under the principles of sections 72 and 402 of the Code.

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This ruling is based on the assumption that amounts received by the 401(k) plan from Benefit Y may not be withdrawn from the plan prior to a participant attaining normal retirement age while Benefit Y is paying benefits to the plan.

This letter expresses no opinion regarding whether any section 401(k) plan that purchases Benefit Y with employer contributions (including elective deferrals) satisfies the requirements for qualification under section 401(a) of the Code.

This ruling is directed 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.

Sincerely yours,

Donzell H. Littlejohn

Donzell H. Littlejohn, Acting Manager
Employee Plans Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:
Deleted Copy of this Letter
Notice of Intention to Disclose