200031060

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person:
xxxxx
Telephone Number:
xxxxx
In Reference to:
OP:E:EP:T:2

Date:
AUG 26 1999

xxxxx
xxxxx
xxxxx

UL: 401.29-00

Legend:

Employer M = xxxxx

Plan X = xxxxx

Policy B = xxxxx

Company C = xxxxx

State A = xxxxx

Dear xxxxx:

This is in response to the ruling request dated xxxxx, 1998, as submitted by your authorized representative, regarding tax consequences to participants on amounts paid for, and amounts paid to Plan X under a long-term disability insurance policy (LTDI). In addition, this is to confirm receipt of the letter dated xxxxx, 1999, from your authorized representative withdrawing ruling request number 5 of the original submission.

The following facts and representations have been submitted:

Employer M sponsors Plan X, a qualified profit-sharing plan under section 401(a) of the Internal Revenue Code that includes a cash or deferred arrangement (CODA) as described in section 401(k)(2) of the Code. Plan X, adopted by Employer M effective January 1, 1984, covers the employees of Employer M as well as those of certain affiliate employers. Employer matching contributions, profit-sharing contributions, qualified nonelective contributions (QNECs) and employee elective contributions are provided for under section 3.1 of the Plan X document.

In order to provide for the continuation of benefit accumulations that otherwise would not result if an active participant in Plan X became unable to work due to disability, Employer M intends to allow participants in Plan X to direct Plan

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X's trustee to allocate a portion of their salary deferral contributions to purchase LTDI through Plan X. The premium will be deducted from the participant's Plan X account on a monthly basis.

A Plan X participant who meets the eligibility requirement of Policy B on December 31 of any plan year will be eligible to receive coverage beginning the following January 1. If the participant subsequently suffers a disability while covered under Policy B, the Plan X trust will begin receiving amounts under Policy B after a 365-day waiting period has been satisfied.

Policy B is a non-participating group policy providing for LTDI. Policy B is sponsored by Company C, a life insurance company under the jurisdiction of State A. Plan X will be the purchaser and policyholder of Policy B, not the individual participants from whose accounts employee elective deferrals will be deducted monthly to fund such purchase. Policy B must pay benefits directly to Plan X and a participant cannot assign his or her benefits under Policy B to Plan X. Under the provisions of Policy B, it may be cancelled by Company C or by Plan X, as policyholder.

Upon completion of the waiting period, the Plan X trust will receive from Policy B, on a monthly basis, an amount equal to 1/12 of the elective deferrals, employer matching contributions and QNECs made to Plan X on behalf of a participant for the plan year immediately preceding the year in which the disability began. Policy B will continue to pay the monthly amounts to the Plan X trust until the earliest of (i) the employee's recovery from the disability, (ii) the participant's death, (iii) the termination of Plan X, (iv) the participant's withdrawal of all or a portion of his account attributable to Policy B proceeds, or (v) the maximum payment period determined on the basis of age category at the onset of the disability.

It is represented that Policy B payments to Plan X on account of a plan participant becoming disabled are plan investment earnings and such earnings can be used to continue accumulations under Plan X.

Amounts received by Plan X under Policy B and credited to participants' accounts will generally be treated the same as any other accumulations under Plan X, and participants in Plan X will be permitted to direct the investment of such amounts as they would have been permitted to do had they been able to continue making salary deferrals to Plan X. Employer M proposes to amend Plan X to provide that amounts received by Plan X under Policy B may not be withdrawn from Plan X prior to a participant attaining normal retirement age while Policy B is paying monthly benefits to Plan X.

XXXXX XXXXX

Based on the above facts and representations, the rulings requested are as follows:

1) Participants in Plan X who elect coverage under Policy B will not be currently taxed on the cost of coverage.

2) Amounts paid to Plan X under Policy B are not annual additions subject to the limits of Code section 415(c).

3) Amounts paid under Policy B are not taxable to participants when paid to Plan X.

4) Plan distributions to participants of amounts received from Policy B, and earnings thereon, will be fully taxed to participants under Code section 402(a).

6) The purchase of the coverage will not violate the "contingent benefit" prohibition of Code section 401(k)(4)(A).

Section 1.401-1(b)(5) of the Income Tax 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.

Code section 414(i) defines the term "defined contribution plan" as a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants that may be allocated to such participant's account.

With respect to ruling request one, Code section 402(a) provides that except as otherwise provided in this section, any amount actually distributed to any distributee by any 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 (relating to annuities).

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Policy proceeds, like the return on any other Plan X investment, increase the accumulations in Plan X that will be payable to the participant or beneficiary when a distribution event, as defined in Plan X, actually does occur. Meanwhile such proceeds generally may not be accessed by the participant. Policy B and any proceeds of Policy B remain assets of Plan X and no distribution within the meaning of section 402 of the Code results when a portion of a Plan X participant's elective deferrals are invested in Policy B.

Although a ruling with respect to the application of the incidental benefit rule is not among the list of rulings requested on your behalf, our opinion as to its application to the facts and representations of this case is as follows: 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 the case of Plan X, the Plan itself is the designated beneficiary for any payments made from Policy B. Because Policy B and the proceeds of Policy B remain assets of Plan X, there is no taxable "distribution" within the meaning of section 402 of the Code when Policy B is purchased by the Plan. Nevertheless, payments from the Policy to Plan X will result in an increase in the balance in the participant's account just as if the participant had continued to make contributions to Plan X. Providing protection to the Plan X participant from the economic loss that would occur if he or she were unable to continue to make contributions to Plan X is a current benefit (although not distributed). Consequently, the payment of premiums under Policy B on behalf of a participant is an incidental insurance benefit that is subject to the limitations set forth in the published guidance. Thus, Plan X would fail to satisfy section 401(a) of the Code if on behalf of a participant, premiums paid under Policy B, plus any other incidental insurance benefits, exceed the permitted limitations on such benefits.

Accordingly, with respect to ruling request one, we conclude that because the purchase of coverage under Policy B will not constitute a distribution to the participant, participants in Plan X who elect coverage under a LTDI policy will not be currently taxed on the cost of coverage.

With respect to ruling request two, Code section 415(c)(1) provides, in general, that contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition (within the meaning of paragraph (2)) to the participant's account, such annual addition is greater than the lesser of --

xxxxx xxxxx

(A) $30,000, or
(B) 25 percent of the participant's compensation.

Code section 415(c)(2) defines the term "annual addition" as the sum for any year of --

(A) employer contributions,
(B) the employee contributions, and
(C) forfeitures.

In the case of Plan X, Policy B proceeds are neither employer contributions nor employee contributions nor forfeitures.

Accordingly, with respect to ruling request two, we conclude that amounts paid to Plan X under a LTDI policy are not annual additions subject to the limits of Code section 415(c).

With respect to ruling request three, Code section 402(a), as set forth above, and section 1.402(a)-1 of the Regulations address the taxation of a beneficiary of a qualified employees trust.

Any Policy B proceeds that are paid to the Plan X trust are considered Plan X earnings. Under the purpose and payment process of Policy B, there is no direct payment to the Plan X participant and no benefit proceeds are made available to the participant. No distributable event under the terms of Plan X occurs at the time at which Policy B proceeds are paid to the Plan X trust for allocation to a participant's account for the purpose of the continuation of the participant's retirement accumulations during the disability period. Under the rules of Code section 402 and the applicable regulations, with regard to Policy B, there is no taxation of a Plan X participant until some amount from the LTDI policy is distributed or made available to the participant.

Accordingly, with respect to ruling request three, we conclude that amounts paid under a LTDI policy are not taxable to participants when paid to Plan X.

With respect to ruling request four, 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.

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In general, cash distributions from CODAs 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. In this case, none of the Plan X distributions to a plan participant will be attributable to contributions that were previously taxed.

Accordingly, with respect to ruling request four, we conclude that Plan X distributions to participants of amounts received from a LTDI policy, and any earnings on such earnings, will be fully taxed to participants under Code section 402(a).

With respect to ruling request six, Code section 401(k)(4)(A) 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.

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

Accordingly, with respect to ruling request six, we conclude that the purchase of the coverage of a LTDI policy will not violate the "contingent benefit" prohibition of Code section 401(k)(4)(A).

This ruling only addresses the taxability issues under sections 402 and 72 that relate to Plan X. Furthermore, this ruling is based on the assumption that Plan X remains a qualified plan at the time of the transaction.

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

xxxxx xxxxx

A copy of this ruling is being sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2

Enclosures:
Deleted copy of this letter
Notice of Intention to Disclose

cc:
xxxxx
xxxxx
xxxxx
xxxxx

District Director
xxxxx Key District Office
Attn: Chief, EP/EO