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Retirement plan disability premiums, but not most medical, can escape income inclusion

Final IRS regulations open the door for defined contribution plan disability insurance that funds plan contributions when a participant is disabled. The regulations also clarify the income taxation results when using qualified retirement plans to fund other accident or health benefits. Aside from income exclusions for retiree health benefits funded via Code section 401(h) accounts and for premiums paid on behalf of retired public safety officers, premiums for such benefits are treated as taxable distributions when paid from a retirement plan.

Background

In 2007, IRS issued proposed regulations affirming earlier guidance on the use of retirement plan assets to pay accident and health insurance premiums. When premium payments for such insurance are paid from retirement plan assets, they are generally treated as retirement distributions that are taxable to the employee. Any accident or health insurance benefits paid to a retirement plan's trust would generally be treated as participant after-tax contributions subject to the annual additions limitation under Code section 415(c). This would be problematic in years when the participant's compensation from the employer drops below the amount of the insurance benefits paid to the plan.

Several comments on the proposed regulations recommended an exception for disability insurance that operates like a "waiver of premium" arrangement to replace retirement plan contributions. This arrangement would allow defined contribution plans to address the important problem of replacing the employee and employer contributions that stop when a plan participant is not able to continue working. Indeed, some employers had already implemented such programs based on the receipt of favorable private letter rulings. When the proposed rules did not address these arrangements, it discouraged others from following suit.

Tax treatment of accident and health insurance premiums

In final regulations issued May 12, the IRS followed their proposed rules, but added a new exception for providing disability-related benefits through a qualified plan. The final regulations apply to taxable years that begin on or after January 1, 2015, but taxpayers may elect to apply them to earlier taxable years.

Generally, payments from retirement plan assets to pay premiums for a participant's accident, health insurance, or qualified long-term care insurance are characterized as distributions from the plan that are taxable to the participant in the year in which the premium is paid unless a statutory exemption applies. The statutory exemptions include distributions that are paid from a qualified retiree health account under Code section 401(h) or for qualified public safety officers under Code section 402(l). More information on the statutory exemptions is described below.

Such premiums for medical or qualified long-term care insurance may be deductible for employees who itemize deductions on their federal income tax return if the total amount of their medical care expenses exceeds 10% of adjusted gross income.

The taxation of any benefits received from the insurance obtained with the payment would be no different than had the participant paid the premiums with other after-tax dollars. For example, benefits paid to, or on behalf of, the employee under a health or accident insurance policy (including disability) purchased by the employee on an after-tax basis would not be includable in the employee's income. If the qualified plan's trust is the beneficiary of the policy and the insurer pays the benefit to the insured's retirement plan account, the payment would be treated as an after-tax employee contribution to the plan — and that would be subject to the Code section 415(c) maximum annual addition.

Maximum annual addition

The defined contribution maximum annual addition caps all contributions (other than age 50 catch-up contributions) and forfeitures allocated to a participant's defined contribution plan account at the lesser of 100% of compensation, or an inflation adjusted dollar limit — $52,000 in 2014.

Statutory retiree medical exceptions

The final regulation notes two statutory exceptions for retiree medical expenses. The first covers expenses paid from a pension or annuity plan from a Code section 401(h) account. Medical premiums and medical benefit payments from the 401(h) account are not taxable to the participant if the otherwise applicable rules for medical plan exclusions are met.

The second exception applies to eligible retired public safety officers who can elect to exclude up to $3,000 per year of qualified health insurance premiums, including premiums for long-term care coverage, distributed from a governmental plan directly to the insurer. The governmental plan can be a qualified plan, a 403(b), or a 457(b) plan. Those making this election are not entitled to take an itemized deduction for medical expenses on their tax return for the amount excluded. The coverage can be for retired public safety officers as well as their spouses, dependents, and children (up to the end of the year in which the child attains age 26).

Retirement contribution disability replacement option

The regulations include a new rule for certain incidental disability insurance coverage that allows defined contribution plans to offer participants the opportunity to insure future contributions that may be lost if they incur an employment-ending disability. If the terms of the rule are met, the payment of the premium is treated as an investment of the participant's account and is not includible in the gross income of the participant. Disability benefit payments made to the trust under the arrangement are treated as investment earnings of the participant's account (and do not count toward the maximum annual addition). When subsequently paid from the plan, these amounts are generally includible in gross income under the usual rules for qualified plan distributions. The special rule is not available if the employer self-insures the disability benefit.

Conditions necessary for disability insurance exception. To be eligible for this “investment” treatment, the disability benefit must satisfy all of the following requirements:

- The premiums for the disability insurance contract must be paid directly from the plan.
- The plan must receive the insurance benefits paid under the contract as a result of the employee’s inability to continue employment with the employer due to disability.
- The benefit payments credited to the participant’s account cannot exceed the annual contributions that the employee and employer were reasonably expected to make to the plan during the period of disability, reduced by any contributions actually made to the employee's account during that period.

The reasonable expectation standard allows the coverage to reflect reasonable future salary increase expectations in determining the employee and employer contributions that would have been made during a period of disability. Guidance was not provided about how to determine a reasonable salary increase expectation for this purpose. The regulations do provide a helpful example showing that the insurance can replace elective, matching, and nonelective contributions. Arguably, the insurance could also replace after-tax or Roth contributions, with replacement contributions being allocated to the corresponding accounts as investment income. The regulation points out that future guidance may address the tax treatment of the coverage.

> Buck comment. As with any insurance product purchased with plan assets, the selection of the specific insurance policy to provide the disability benefit would be a fiduciary decision.

Result for noncompliant program. If the disability benefit exceeds the annual contributions reasonably expected to be lost as a result of the disability, all of the premium payments (not just the excess) would be treated as a distribution. In addition, all of the benefits from the coverage paid to the plan would be treated as after-tax contributions. These after-tax contributions, combined with any other contributions for the plan year, would be subject to the Code section 415(c) maximum annual addition. Contributions for some participants receiving these after-tax amounts could breach the 100% of compensation limit because only taxable disability pay would be considered pay for this purpose. Although there is a special rule for imputing compensation for individuals who are permanently and totally disabled, it only helps participants who meet the stringent definition of disability contained in the Code in plans that immediately vest contributions made due to disability. In addition, highly compensated employees are not covered by the special rule for imputing compensation unless the plan provides for the continuation of contributions for all permanently and totally disabled participants for a set period of time.

In closing

Disability can have a devastating impact on an employee’s income and ability to continue funding for retirement. The final IRS regulation opens the door for a specialized type of disability product that can be used in a qualified plan or 403(b) plan. As demand grows and product ideas expand, plan sponsors will be better positioned to evaluate the best options for participants, taking into account underwriting limits, premium costs, and alternative policies that may be available outside of the plan on an after-tax basis.

In addition to making appropriate disability income products available to employees, employers may wish to educate employees about the risk that disability poses to their living standards after normal retirement age (when benefits under most long-term disability plans cease).

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