

Rev. Rul. 61-164

1961-2 C.B. 99

SECTION 401. - QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

26 CFR 1.401-1: Qualified pension, profit-sharing and stock bonus plans.

July, 1961

The purchase by a trust established under an employees' profit-sharing plan of incidental amounts of life, accident or health insurance for the benefit of an employee or his family, with funds allocated to his account that have not been accumulated for the period prescribed by the plan for the deferment of distributions, will not prevent qualification of the plan under section 401(a) of the Internal Revenue Code of 1954.

Advice has been requested as to the effect upon the qualification of an employees' profit-sharing plan under section 401(a) of the Internal Revenue Code of 1954 of a provision in the plan for the purchase of major medical hospitalization insurance for the employees.

An employer established an employees' profit-sharing plan and, in addition, provided the employees with group hospitalization insurance. This insurance coverage was extended to include major medical benefits. Its cost was paid by the trust established under the plan with funds that had not been accumulated for the period prescribed by the plan for the deferment of distributions. Each participant's account under the plan was charged with the cost of the additional benefits obtained for him. The plan does not prohibit the use in this manner of funds allocated to the participating employees' accounts.

A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amount allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance. Section 1.401-1(b) (1) (ii) of the Income Tax Regulations.

The use of trust funds to pay the cost of major medical insurance for an employee or his beneficiaries is a "distribution" within the meaning of section 402 of the Code. If such insurance may be purchased only with funds that have been accumulated for the period required by the plan for the deferment of distributions, there is no limit to the amount of such insurance that may be purchased. If, however, the plan permits the use of funds that have not been so accumulated to purchase such insurance, the amount of the premiums must be no more than "incidental". Section 1.401-1(b) (1) (ii) of the regulations.

There is no provision in the instant profit-sharing plan that requires the accumulation of funds for the period prescribed by the plan for the deferment of distributions before they can be used to purchase the major medical insurance. Accordingly, the trust established under the profit-sharing plan will not qualify under section 401(a) if the cost of such insurance is more than "incidental" in relation to the amounts credited to the respective employee's account that have not been so accumulated.

Distributions, in the form of one or more permissible benefits such as life, accident or health insurance (to the extent that each such benefit constitutes a "distribution"), will be treated as "incidental" if in the aggregate they do not exceed 25 percent of the funds allocated to a participant's account that have not been so accumulated. This treatment is consistent with the acquiescence in *Raymond J. Moore*, 45 B.T.A. 1073, C.B. 1943, 17, and with Revenue Ruling 54-51, C.B. 1954-1, 147. In the *Moore* case, the cost of the pure insurance element in the retirement income contract (which alone constituted a "distribution" to the employee) purchased by the trust varied from approximately 17 percent for an employee age 25 at date of issue to 6 percent for an employee age 55 at the date of issue. Revenue Ruling 54-51 treated as "incidental" the purchase by a qualified profit-sharing trust of ordinary life insurance where (1) the aggregate premiums in the case of each participant was less than one-half of the aggregate contributions allocated to his account at any particular time; and (2) the plan required the trustee to convert the entire value of the life insurance contract at or before retirement to provide periodic income so that no portion of such value might be used to continue life insurance

protection beyond retirement. The cost of the pure insurance protection in such contract (which alone constituted a "distribution" to the employee) was approximately one half of its total cost.

Accordingly, that part of the cost of the permissible benefit which was a "distribution" could not exceed 25 percent of the funds allocated to an employee's account that had not been accumulated for the period prescribed by the plan for the deferment of distributions. This percentage exceeds that permitted in the Moore case and represents the maximum that will be treated as "incidental."

The foregoing interpretation of "incidental" will be applied with respect to qualified plans providing one or more life or accident or health insurance benefits for participants with funds that have not been accumulated for the period prescribed by the plan for the deferment of distributions, as follows:

(1) If only ordinary life insurance contracts are purchased, the amount expended for premiums may not exceed that percentage permitted in Revenue Ruling 54-51.

(2) If only accident and/or health insurance contracts (including hospitalization, major medical, or similar types of insurance) are purchased, the amount expended for premiums may not exceed 25 percent of the funds allocated to an employee's account that have not been accumulated for the period prescribed by the plan for the deferment of distributions.

(3) If both ordinary life and accident and/or health insurance contracts are purchased, the amount expended for the accident and/or health insurance premiums plus one-half of the amount expended for the ordinary life insurance premiums may not, in the aggregate, exceed 25 percent of the funds allocated to an employee's account that have not been accumulated for the period prescribed by the plan for the deferment of distributions. At no time during the life of the plan may this percentage be exceeded.

The following example will illustrate the interpretation of the term "incidental." The account of an employee who participates in a profit-sharing trust has been allocated \$1,000, no part of which has been accumulated for the period prescribed by the plan for the deferment of distributions:

(1) If only ordinary life insurance contracts are purchased by the trust for the employee, not more than \$500 may be used to pay the premiums for such contract.

(2) If only accident and/or health insurance contracts are purchased, not more than \$250 may be used to pay the premiums for such contracts.

(3) If both ordinary life insurance contracts and accident and/or health insurance contracts are purchased and \$300 has been expended to pay the premiums for the ordinary life insurance, not more than \$100 may be used to pay the premiums for the accident and/or health insurance contracts.

Where a trust established under a profit-sharing plan is committed to the payment of annual premiums for permissible insurance benefits for its participants, a reduction in profits which would be accompanied by a reduction in employer contributions under the plan might result in either (a) failure to pay the premiums due or (b) payment of the premiums with funds that have not been accumulated for the period prescribed by the plan for the deferment of distributions in an amount in excess of that which is "incidental". The latter alternative will result in disqualification of the trust under section 401(a) of the Code.

The amendment of an existing plan to provide permissible benefits will not be considered a curtailment of the plan if the employer's contributions to the plan are not reduced thereby.

Accordingly, it is held that the purchase by a trust established under an employees' profit-sharing plan of major medical hospitalization insurance, which constitutes a "distribution" to an employee of funds allocated to his account that have not been accumulated for the period prescribed by the plan for the deferment of distributions, will be treated as "incidental" and will not, therefore, prevent qualification of the trust under section 401(a) of the Code if the amount expended, when added to other permissible benefits (to the extent that each such benefit constitutes a "distribution") also purchased by the trust with funds allocated to his account that have not been accumulated for the period prescribed

by the plan for the deferment of distributions, does not exceed 25 percent of the total of the funds allocated to his account that have not been so accumulated.