

Section 125.—Cafeteria Plans

(Also Section 402(a).)

Taxability of distributions of employee's trust. This ruling provides that amounts distributed from a qualified retirement plan that the distributee elects to have applied to pay health insurance premiums under a cafeteria plan are includable in the distributee's gross income. The holding also extends to situations where amounts distributed from the qualified retirement plan are applied directly to reimburse medical care expenses incurred by a participant in the qualified retirement plan.

Rev. Rul. 2003-62

ISSUE

Whether amounts distributed from a qualified retirement plan that the distributee elects to have applied to pay health insurance premiums under a cafeteria plan are includable in the distributee's gross income under § 402(a) of the Internal Revenue Code, and whether the same conclusion applies if amounts distributed from the qualified retirement plan are applied directly to reimburse medical care expenses incurred by a participant in the qualified retirement plan.

FACTS

Employer M maintains a plan qualified under § 401(a) that provides retirement benefits for employees. M also maintains a health plan for employees, former employees, their spouses, and dependents that is partially paid through a cafeteria plan under §125 for employees. Under M's health plan, former employees may elect to have distributions from the qualified retirement plan applied to pay for the health insurance premiums under the cafeteria plan.

LAW AND ANALYSIS

Section 106 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 the gross income of an employee does not include contributions which the employee's employer makes to an accident or health

plan for compensation (through insurance or otherwise) for personal injuries or sickness to the employee or the employee's spouse or dependents (as defined in § 152).

Under § 125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident and health coverage. Pursuant to § 125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it is available to the employee and the employee could have chosen to receive cash instead. If an employee elects to apply the salary reduction amount to purchase accident or health coverage pursuant to § 125, the accident or health coverage is excludable from gross income under § 106 as employer-provided accident or health coverage.

Section 402(a) applies to distributions from a retirement plan that is qualified under § 401(a). Under § 402(a), except as otherwise provided in § 402, any amount actually distributed to any distributee by a qualified retirement plan is taxable to the distributee, in the taxable year of the distributee in which distributed, under § 72 (relating to annuities). There are two exceptions from the general rule of includability of distributions in gross income (at § 402(c) relating to rollovers and at § 402(e)(4) relating to net unrealized appreciation in employer securities), neither of which relates to cafeteria plans.

Rev. Rul. 61-164, 1961-2 C.B. 99, considers the effect upon the qualification under section 401(a) of an employer's profit-sharing plan of a provision in the plan for the purchase of major hospitalization insurance for the employees. The ruling concludes that although the purchase of the major hospitalization insurance does not prevent the qualification of the plan if the insurance is deemed to be "incidental," the use of the funds to pay for the employees' medical insurance is a "distribution" within the meaning of § 402.

Rev. Rul. 69-141, 1969-1 C.B. 48, considers whether distributions made from a qualified profit-sharing plan to pay an employee-participant for medical care expenses are excludable from the employee-participant's gross income. An option in the

plan provides that in the event an employee-participant incurs medical expenses for the employee, the employee's spouse, or the employee's dependents, the employee may apply for an advance distribution from his account in the plan, provided that the aggregate distributions made pursuant to this option do not exceed 49 percent of the amount of funds in the account and the funds to be distributed have been credited to the account for a period of at least two years. The ruling states that distributions from the qualified profit-sharing plan for medical care expenses incurred by an employee-participant are taxable to the participant under § 402(a).

Neither of the exceptions in § 402 to the general rule of § 402(a) allows a participant to exclude from gross income amounts distributed from a qualified retirement plan and applied to the purchase of benefits under the cafeteria plan. Accordingly, the general rule of § 402(a) applies and the distribution is includable in the distributee's gross income. The same conclusion applies if distributions from the qualified retirement plan were applied directly to reimburse medical care expenses incurred by a plan participant.

HOLDING

Amounts distributed from a qualified retirement plan that the distributee elects to have applied to pay health insurance premiums under a cafeteria plan are includable in the distributee's gross income. The same conclusion applies if amounts distributed from the qualified retirement plan are applied directly to reimburse medical care expenses incurred by a participant in the qualified retirement plan.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling as it pertains to § 125 (cafeteria plan) matters, please contact Ms. Tanner at (202) 622-6080 (not a toll-free number). For further information

regarding this revenue ruling as it pertains to § 402 (rollover) matters, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday or Mr. Linder at (202) 283-9888 (not a toll-free number).