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# New Final Regulations Allow Tax-Free Purchase of Disability Insurance by Plans

## Services

Employee Benefits & Executive Compensation

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On May 9, 2014, the Internal Revenue Service and U.S. Department of the Treasury issued final regulations regarding the tax treatment of premium payments made by qualified defined contribution retirement plans for accident or health insurance on behalf of plan participants. The regulations contain a special rule that makes the purchase of disability insurance by a plan not taxable to participants in certain circumstances.

The special rule applies to a plan's purchase of disability insurance that, upon a participant's disability, would make payments to the plan to replace the employer contributions that would have been made on behalf of the participant if the participant were not disabled. Under the special rule, a participant would not be taxed on the premiums paid for this type of disability coverage, or on the disability payments to the plan that are allocated to the participant's account. Instead, the disability insurance is treated like a plan investment that is not taxable until the participant receives a distribution.

To realize these tax benefits, a disability insurance contract must satisfy all of the following requirements:

The insurance contract must provide for payments to the plan if the participant cannot work due to disability.

The amount of disability payments may not exceed the reasonably expected amount of annual contributions that would have been made to the plan during the period of disability, reduced by any other contributions credited to the participant's account during such period. This would allow the disability payments to reflect expected future salary increases.

The insurance coverage is not self-insured by the employer, but instead is purchased from a third party insurer.

For example, suppose a participant has annual compensation of $150,000 and the employer typically makes a contribution equal to 10 percent of compensation. The final regulation would allow the plan to purchase disability insurance that would pay $15,000 per annum to the plan for allocation to the participant's account during the period of disability, even though the participant had no compensation to receive an allocation of the employer contribution for the period of disability.

## What This Means to You

Employers with defined contribution plans may consider adding disability protection to their self-directed plans that employees may elect. By doing so, employees may obtain the security, on a tax-favored basis, of knowing that their retirement accounts will not suffer if they have a disability that prevents them from working. Offering such disability protection may require a plan amendment.