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Speakers Oppose Proposed Changes to Treatment of Insurance in Deferred Compensation

by Sam Young

Speakers at an IRS hearing on December 6 argued that proposed section 402 regulations are a misguided intrusion into an area of employee benefits that was better addressed by letter rulings.

Under the proposed regs (REG-148393-06), accident or health insurance premiums paid by a qualified deferred compensation plan would be section 402(a) distributions includable in the employee's taxable income under section 72. The payouts from insurance obtained by the plan would be excluded from gross income under section 104(a)(3). Distributions for premium payments would also not be excludable from income. Exceptions are provided for medical accounts complying with section 401(h). (For the regs, see Doc 2007-19167 [PDF] or 2007 TNT 161-5 .)

Letter Rulings

The three speakers at the hearing all focused on the effect that provision would have on employees accepting long-term disability (LTD) payments, and they argued that premiums paid by a qualified plan should be treated as investments made by the plan on behalf of an employee, as they were in LTRs 98-52026 (see Doc 99-26 or 98 TNT 249-25), 2000-31060 (Doc 2000-20750 or 2000 TNT 152-25), and 2002-35043 (Doc 2002-20083 [PDF] or 2002 TNT 170-33).
Harlan Weller of Treasury's Office of Tax Policy was skeptical of the letter rulings' position. He reminded the audience that letter rulings are not binding, are created by low-level officials, and are not reviewed by Treasury.

Louis Mazawey of Groom Law Group argued that the letter rulings' treatment allowed greater integration of LTD with existing plan features, making administration and documentation more efficient. There may be other ways to address individual policy issues, he said, "and that would be a good thing, but it's not nearly as good a thing as what the rulings permit," especially for small employers.

Richard Shea of Covington & Burling called the letter rulings "a very elegant solution" and suggested that they would be difficult to abuse. He also agreed with Mazawey that to make defined contribution plans complete retirement solutions, they would have to include LTD provisions.

Moral Hazard

Weller asked the speakers to comment on whether insurance contracts' size should be limited and whether those restrictions should be based on legal or underwriting considerations.
Marcia Wagner of the Wagner Law Group, speaking for the Pension Advisory Group, responded that restrictions on the size of insurance contracts would be limited by the market. Underwriters would be unwilling to issue LTD larger than the employee's compensation and employers would be reluctant to allow a plan to purchase it, she said.

Shea agreed, saying that the moral hazard of incentives against work would be something that employers and insurers would watch for.

Nonetheless, Marjorie Hoffman, special counsel in the IRS Employee Plans division, expressed concern that in case of disability, employees might be able to draw on deferred compensation, as she said is allowed under most 401(k) plans, as well as LTD. That would cut against Shea's moral hazard argument, she suggested.

Shea responded that in his experience, LTD benefits are generous enough that employees are not tempted to draw on their deferred compensation, and that even combined, a deferred compensation disability benefit and LTD are unlikely to exceed an employee's normal compensation. LTD is typically around 60 or 65 percent of base pay, while a 401(k) plan will provide between 10 and 30 percent, he said.

Public Policy

Wagner argued that the proposed regs contradict letter rulings, the Small Jobs Protection Act of 1996, and the Tax Equity and Fiscal Responsibility Act of 1984 by effectively taxing LTD benefits. That would be contrary to the public policy of facilitating benefits for disabled employees, she added.

The regs are intended to prevent abuses similar to the so-called dual-purpose plans under section 105(b) and (c) that allowed employees to convert deferred compensation into untaxed health benefits, Wagner said. However, LTD benefits are taxable under section 105(a) and therefore do not present the same risk, she argued. "You're trying to kill a problem that doesn't exist. . . . There's no tax game to play here," she said.

Separate Treatment

Mazawey said that LTD is "a very fundamental thing for 401(k) plans to be able to do," but that its proposed treatment suggests that it "just tripped over" into the regs. It is too important an issue not to get more targeted treatment and so should receive independent regs, he argued.