Part I

Section 411.--Minimum Vesting Standards

26 CFR 1.411(a)-1: Minimum vesting standards; general rules.
(Also, §§105, 7805; 301.7805-1.)

Rev. Rul. 2005-55

ISSUE

Does a profit-sharing plan fail to satisfy the requirements of § 401(a)(7) of the Internal Revenue Code if it provides a medical reimbursement account for each participant from which payments may only be distributed to reimburse the participant for expenses for medical care?

FACTS

Employer M maintains Plan A, a nongovernmental profit-sharing plan that is intended to be a qualified plan under § 401(a). Plan A includes two separate accounts for each participant: a profit-sharing account and a medical reimbursement account. Plan A provides that 75% of Employer M's annual contributions to Plan A on behalf of each participant is allocated to that participant's profit-sharing account and the remaining 25% is allocated to the participant's medical reimbursement account. Plan A does not provide for (after-tax) employee contributions.

Plan A provides that amounts in a participant's medical reimbursement account may be used to reimburse the participant for any substantiated

expenses for medical care (as defined by § 213(d)) incurred by the participant or the participant's spouse and dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)). Plan A also expressly provides that under no circumstances may amounts held in the medical reimbursement account be distributed except to reimburse the participant for expenses for medical care incurred by the participant or the participant's spouse or dependents. The restriction on use of the medical reimbursement account applies to all participants in the plan (i.e., current and former employees, including retired employees). Plan A further provides that, upon the death of the participant, the account is available only to reimburse expenses for medical care of the participant's spouse or, if unmarried or the spouse consents (in the manner required under § 417(a)(2)), the medical care expenses of the participant's dependents, if any, and is only available for that purpose as long as those individuals qualify as the participant's spouse and dependents for purposes of § 105(b). If there is no surviving spouse or dependent(s), upon the participant's death, or at such time when no individual qualifies as a surviving spouse or dependent for purposes of § 105(b), any remaining unused portion of the medical reimbursement account will be forfeited and will be applied to reduce future employer contributions to medical reimbursement accounts under the plan.

Plan A provides that amounts in the profit-sharing account of each participant (and not amounts in the medical reimbursement account of the participant) are available for distribution to the participant after severance from employment with Employer M.

LAW

Section 401(a) provides requirements for a trust forming part of a stock bonus, pension or profit-sharing plan to be qualified under § 401(a). A profit-sharing plan is a type of defined contribution plan. Section 414(j) provides that a defined contribution plan is a plan which provides an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to the participant’s account.

Section 1.401-1(b)(1)(ii) of the Income Tax Regulations provides that a profit-sharing plan, within the meaning of § 401, must provide for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. Section 1.401-1(b)(1)(ii) further provides that a profit-sharing plan is primarily a plan of deferred compensation but the amounts allocated to the account of a participant may be used to provide incidental life or accident or health insurance for him and his family.

Section 402(a) generally provides that any amount distributed to any distributee from a plan qualified under § 401(a) is taxable to the distributee, in the taxable year in which distributed, under § 72.

Rev. Rul. 61-164, 1961-2 C.B. 99, provides that a profit-sharing plan does not violate the incidental benefit rule in § 1.401-1(b)(1)(ii) merely because, in accordance with the terms of the plan, each participant’s account under the plan

is charged with the cost of the major medical benefits for the participant under the group hospitalization insurance for the employer's employees, provided that the total amount used for life or accident or health insurance for him and his family is incidental. The revenue ruling further provides that such insurance will be treated as incidental if the amount expended for such benefits does not exceed 25% of the funds allocated to a participant's account that have not been accumulated for the period prescribed by the plan for the deferment of distributions. However, Rev. Rul. 61-164 provides that the incidental benefit requirement does not limit the amount expended for such benefits from funds allocated to a participant's account that have been accumulated for the period prescribed by the plan for the deferment of distributions. The revenue ruling also 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.

Section 401(a)(7) provides that a trust shall not constitute a qualified trust unless the plan of which such trust is a part satisfies the requirements of § 411.

Section 411(a) describes minimum vesting standards that a retirement plan subject to that section must satisfy in order for the plan to be qualified under § 401(a). These standards include § 411(a)(2), which requires that an employee's accrued benefit derived from employer contributions become nonforfeitable in accordance with one of the two schedules specified in § 411(a)(2). Section 411(a)(7) and § 1.411(a)-7(a)(2) provide that, in the case of a

defined contribution plan, an employee's accrued benefit is the balance of the employee's account under the plan.

Notwithstanding § 411(a)(2), § 411(a)(3) and § 1.411(a)-4(b) permit the forfeiture of an employee's accrued benefit under certain circumstances. These permissible forfeitures include forfeitures on account of death.

Section 1.411(a)-4T(a) provides that, for purposes of § 411, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. The regulation further provides that, subject to the permissible forfeitures of § 411(a)(3) and § 1.411(a)-4(b) and certain other prescribed situations, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time.

Section 105(a) provides that, except as otherwise provided in § 105, amounts received by an employee through accident or health insurance for personal injuries or sickness are included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer. Section 105(b) provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 for any prior taxable year, gross income does not include amounts described in § 105(a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in § 213(d)) of the

taxpayer or the taxpayer's spouse or dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)).

Section 1.105-2 of the regulations provides that only amounts that are paid specifically to reimburse the taxpayer for the expenses incurred by the taxpayer for medical care (as defined in § 213(d)) are excludable from gross income. Section 105(b) does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether the taxpayer incurs expenses for medical care. Accordingly, if an employee is entitled to receive the payment irrespective of whether or not any medical expenses have been incurred, none of the payments are excludable from gross income under § 105(b), even if the employee has incurred medical expenses during the year. See Rev. Rul. 2002-80, 2002-2 C.B. 925, and Rev. Rul. 2005-24, 2005-16 I.R.B. 892.

Finally, Congress has specifically prescribed rules relating to the funding of future health benefits on a tax-favored basis. For example, such funding is addressed by the rules in §§ 419, 419A, 501(c)(9), and 512 for welfare benefit funds (including Voluntary Employees' Beneficiary Associations) and by §§ 401(h) and 420 with respect to retiree health benefits provided through a qualified plan.

ANALYSIS

Under a profit-sharing plan, as a defined contribution plan, benefits to a participant must be based solely upon amounts contributed to the participant's account and attributable income, gains, expenses and losses. Under the

§ 411(a)(7) definition of accrued benefit for a defined contribution plan, all amounts credited to a participant's account under the plan are part of the accrued benefit and must satisfy the nonforfeiture requirements of § 411(a)(2).

Plan A provides that under no circumstances may any amounts held in a medical reimbursement account be distributed to any participant except to reimburse the participant for substantiated medical expenses incurred by the participant or the participant's spouse and dependents. Plan A thereby imposes a condition on the entitlement of the participant (and the participant's beneficiaries) to the amounts held in the medical reimbursement accounts and, as a result of that restriction, these amounts fail to be nonforfeitable.

However, if Plan A instead provided that amounts payable from the medical reimbursement account were available for distribution under the same terms as the amounts held in the profit-sharing account (e.g. after severance of employment with Employer M), Plan A would not fail to satisfy § 411 merely because Plan A also permitted amounts held in the medical reimbursement account to be distributed both before and after severance of employment to reimburse medical expenses (or to pay the cost of major medical insurance as described in Rev. Rul. 61-164). However, in that case, no amounts paid from Plan A would be excludable under §105(b). Therefore, any distribution from Plan A would be includable in gross income under § 402(a).

HOLDING

Plan A fails to satisfy the vesting requirements of § 411 because it imposes conditions on the use of the amounts held in the participants' accounts. Accordingly, the plan fails to satisfy § 401(a)(7).

In addition to the requirements of §§ 401(a)(7) and 411, a profit-sharing plan which only permits distribution of amounts held in a separate medical reimbursement account for reimbursement of substantiated medical care expenses, as described in the facts above, may fail to satisfy various other qualification requirements of § 401(a), including § 401(a)(9), § 401(a)(11), and § 401(a)(14).

CORRECTIVE PLAN AMENDMENTS

Pursuant to the authority contained in § 7805(b) and § 301.7805-1 of the Procedure and Administration Regulations, the Commissioner has determined that a profit-sharing plan or stock bonus plan will not fail to be qualified under § 401(a) for plan years beginning on or before August 15, 2005, merely because the plan provides for a separate medical reimbursement account for each participant and for the amounts in the participant's medical reimbursement account to be only used to reimburse the participant for any substantiated expenses for medical care provided that (i) the plan (including the provisions of the plan relating to the medical reimbursement accounts) is the subject of a favorable determination letter (or in the case of a pre-approved plan, a favorable advisory or opinion letter) issued before August 15, 2005, and (ii) the plan is amended effective on the first day of the first plan year beginning after August 15, 2005, to provide that amounts in each participant's medical reimbursement account are available for distribution under the same terms as amounts held in the participant's other accounts under the plan (e.g. upon severance from employment). Further, any distributions made from a plan that is the same as or similar to the plan described under the FACTS section of this revenue ruling

before the first day of the first plan year beginning after August 15, 2005, to reimburse the participant for any substantiated expenses for medical care (as defined by § 213(d)) incurred by the participant or the participant's spouse or dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)) will not fail to be excluded from income under § 105(b) merely because, due to the publication of this revenue ruling, the plan is amended effective as of the first day of the plan year beginning on or after August 15, 2005, to allow distribution of the amounts held in the medical reimbursement account for reasons other than for reimbursement for any substantiated expenses for medical care.

DRAFTING INFORMATION

The principal author of this revenue ruling is Robert Walsh of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday, by calling (877) 829-5500 (a toll-free number). Mr. Walsh may be reached at (202) 283-9888 (not a toll-free number). For further information regarding this revenue ruling as it pertains to § 105, please contact Barbara E. Pie of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6080 (not a toll-free number).