INTERNAL REVENUE SERVICE

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June 25, 2001

Taxpayer =

Plan =

Dear :

This is in reply to your letter dated January 4, 2001, and subsequent correspondence, requesting rulings on behalf of Taxpayer concerning the Federal income tax treatment under sections 104 and 105 of the Internal Revenue Code (the Code) of long-term disability benefits paid through the Plan.

You represent that Taxpayer provides long-term disability coverage to its eligible U.S. employees through the Plan. Benefits are provided through a group insurance policy with a third-party insurance carrier. The Plan currently provides employees, who become disabled from certain accidental bodily injury, sickness or pregnancy while employed, with basic wage continuation payments at the rate of 60% of salary after the later of the first 180 consecutive days of disability or the expiration of any employer-sponsored short-term disability benefits or salary continuation program (with the exception of benefits required by state law). Under the current terms of the Plan, Taxpayer covers the entire premium for this basic coverage, and the cost of coverage is not included in the gross income of the employees. An eligible employee may also

elect to receive supplemental disability benefits of an additional 6.67% of salary, the premiums for which are payable solely by the employee on a pre-tax basis through the Taxpayer's cafeteria plan.

Taxpayer intends to amend the Plan to provide that each employee (whether current or hired in the future) may elect to pay the full cost of his or her long-term disability coverage on an after-tax basis (the Amended Plan). While the Taxpayer will continue to meet in-full the group policy insurance premiums charged by the third-party carrier for each employee, an appropriate portion of the group premium will be allocated to each employee who elects to meet the cost of coverage on an after-tax basis and will be included in his or her gross income reported each year. If an employee chooses to purchase supplemental coverage, the supplemental coverage must be paid for on the same basis (pre-tax or after-tax) as the employee's basic coverage. In addition, it is represented that basic coverage and after-tax supplemental coverage is not provided through the Taxpayer's cafeteria plan.

Under the Amended Plan, the election to pay for the cost of coverage on an after-tax basis may be made on a year by year basis and must be made in writing prior to the beginning of the Plan year during which the employee will be paying for his or her disability coverage on an after-tax basis. The election is irrevocable for the Plan year once the Plan year begins. Employees hired during the course of a Plan year will be permitted to elect after-tax coverage for the remainder of the Plan year within a certain period (generally, 30 days) following their employment commencement date. Employees will be permitted to make a new election for each Plan year prior to the beginning of that Plan year.

Section 3.01(13) of Revenue Procedure 2001-3, 2001-1 I.R.B. 111, provides that rulings or determination letters will not be issued concerning whether amounts used to provide accident and health insurance under sections 105 and 106 of the Code are includible in the gross income of participants when the benefits are offered through a cafeteria plan.

Section 104(a)(3) of the Code provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer).

Section 1.104-1(d) of the Income Tax Regulations states that if an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his

employees, the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. The regulation refers to section 1.105-1 of the regulations for rules relating to the determination of the amount attributable to employer contributions.

Section 1.105-1(b) of the regulations provides that all amounts received by employees through an accident or health plan which is financed solely by their employer are subject to the provisions of section 105(a).

Amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in gross income under section 105(a) of the Code 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, unless paid as reimbursements of medical expenses under section 105(b) or for the loss or loss of use of a member or function of the body and without regard to absence from work under section 105(c).

Section 1.105-1(c)(1) of the regulations provides that in the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105(a) of the Code applies to the extent that such payments are attributable to contributions of the employer that were not includible in the employee's gross income. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with section 1.105-1(d) in the case of insured plans.

With respect to each employee, the Amended Plan is financed either solely by the Taxpayer or solely by the employee. At no time is the coverage under the Amended Plan financed by both Taxpayer and employee contributions. Accordingly, the Amended Plan is not a contributory plan within the meaning of section 1.105-1(c)(1) of the regulations.

Based on the information submitted and representations made, we conclude as follows:

(1) Long-term disability benefits paid to an employee who has elected, under the Amended Plan, to pay his or her own premiums for basic (and if applicable, supplemental) coverage on an after-tax basis for the Plan year in which he or she becomes disabled, are attributable solely to after-tax employee contributions and excludable from such employee's gross income under section 104(a)(3) of the Code.

(2) Long-term basic disability benefits up to 60% of salary, paid to an employee who has elected, under the Amended Plan, to exclude the premiums paid by the Taxpayer for basic coverage for the Plan year in which he or she becomes disabled, are attributable solely to Taxpayer contributions and includible in such employee's gross income under section 105(a) of the Code.

(3) Pursuant to section 3.01(13) of Rev. Proc. 2001-3, we cannot rule on the taxability of long-term supplemental disability benefits in excess of 60% of salary, paid to an employee who has elected, under the Amended Plan, to have his or her premiums for supplemental coverage paid under the Taxpayer's cafeteria plan.

This ruling is directed only to the taxpayer who requested it. Section 6110 (k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Harry Beker, Chief
Health and Welfare Branch
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:
Copy of this letter
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