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Section 105. - Amounts Received Under Accident and Health Plans

26 CFR 1.105-2: Amounts expended for medical care.

(Also Sections 72, 402; 1.72-15, 1.402(a)-1.)

January, 1969

Distributions made from a qualified profit-sharing trust to pay for medical-care expenses of the employee-participant are not accident and health benefits excludable under section 105(b) of the Code but are taxable under section 402(a) as previously earned deferred compensation.

Advice has been requested whether distributions from a profit-sharing trust, qualified under section 401(a) of the Internal Revenue Code of 1954 and exempt under section 501(a) of the Code, to employee-participants for medical-care expenses incurred by them are excludable from gross income under section 105(b) of the Code.

An option of the plan provides that in the event an employee-participant incurs medical expenses for himself, his wife, or his dependents, he may apply for an advance distribution from his account in the trust. The governing committee that administers the plan determines if a distribution should be made to the participant from the amount credited to his account in the trust. In no event shall the aggregate distributions made pursusnt to this option exceed 49 percent of the aggregate amount of funds allocated to the participant's account at any time. Nor shall any distribution of funds be made until such funds have been credited to the participant's account for a period of at least two years.

The question has been raised whether, because of the provisions of section 1.72-15 of the regulations, distributions made from the trust at the discretion of the governing committee pursuant to the option in the instant profit-sharing plan to pay for medical-care expenses of the employee-participant are excludable from gross income under section 105(b) of the Code.

Section 1.72-15(d) of the regulations provides that any amounts received as accident or health benefits are includible in gross income except to the extent that such amounts are excludable from gross income under section 105 (b), (c), or (d) of the Code.

However, section 1.72-15(e) of the regulations also states that the taxability of amounts that are received under a plan to which this section applies and that are not accident or health benefits is determined under section 72 of the Code without regard to any exclusion or inclusion of accident or health benefits under sections 104 and 105 of the Code.

Section 105(b) of the Code provides, with certain exceptions not here involved, that gross income does not include amounts received by an employee that are attributable to employer contributions to an accident or health plan if such amounts are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred by him for the medical care of himself, his spouse, and his dependents. Section 1.105-2 of the Income Tax Regulation, provides that section 105(b) of the Code does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care.

A profit-sharing plan, within the meaning of section 401(a) of the Code, is a plan of deferred compensation established and maintained by an employer to provide for participation in his profits by his employees or their beneficiaries. To qualify, the plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and 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. See section 1.401-1(b)(1)(ii) of the regulations.

Thus, the amounts contributed by the employer out of its current or accumulated profits, as required in such a plan, represent deferred compensation for services rendered by the employees and are taxable when actually distributed or made available from the trust under section 402(a) of the Code.

A profit-sharing plan referred to in section 401(a) of the Code is distinguishable from a health and accident plan, not only by definition, but in terms of the nature and intent of contributions and benefits provided under each type of plan. The fact that a distribution may be made from a profit-sharing plan in the event of illness does not change the character of the distribution from one of deferred compensation to one of accident or health benefits to which section 105(b) of the Code applies.

Under the profit-sharing plan an employee-participant becomes entitled to the amounts representing his interest thereunder in the trust regardless of whether he incurs expenses for medical care, and any distributions pursuant to the profit-sharing plan prior to retirement or separation from the service merely reduces the amount credited to his account that he may ultimately receive. Further, the use of the money distributed for medical care is no different under these circumstances than the use thereof for other personal expenses.

Accordingly, irrespective of the fact that distributions from the qualified profit-sharing trust here involved are made at the discretion of the governing committee for medical-care expenses incurred by an employee-participant, such distributions are taxable to the participant under section 402(a) of the Code, as previously deferred compensation that has been earned by the performance of services. Therefore, the provisions of section 105(b) of the Code are inapplicable to distributions made pursuant to the profit-sharing plan.