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Voices Tax-free withdrawals from a retirement plan for a disability

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There has been a lot of interest in 401(h) plans after an earlier article we wrote, but also many questions. Most of the questions about 401(h) plans have revolved around the fact that this is a benefit for retirees only. Most people want to know if there is anything that can be done for pre-retirement medical expenses for tax and accounting clients. The answer is yes, thanks to Section 105(c) of the tax code.

What is Section 105(c)?
Section 105(c) applies to amounts received under an accident and health plan. Any amount received under an accident and health plan is tax free as long as it satisfies the requirements of the section.

Can a retirement plan be considered an accident and health plan?

Yes. Under the incidental benefit rule, a retirement plan can be considered an accident and health plan if it contains all of the required language.

When can I expect a 105(c) benefit to be available to me?
Section 105(c) benefits from a retirement plan are only available before you retire. Amounts are usually distributed soon after an injury, disability or disfigurement.

What can a 105(c) benefit pay for?

Unlike the 401(h) plans, Section 105(c) benefits are not paid to reimburse a participant for a qualifying medical benefit. Section 105(c) benefits are paid from a retirement plan due to a disability. The disability must be permanent and calculated without reference to the number of work days missed. Once a client has received a medical diagnosis confirming a disability and/or inability to work, they can receive money from the retirement plan tax free.

How much would a client receive under Section 105(c)?

That would depend on the nature of their injury or disability. Disability payments must be for the loss or loss of use of a member or function of the body. Payments can also be made for a permanent disfigurement. If a client has lost sight in one eye or lost hearing in one ear, they would receive a small disability payment not to exceed your account balance in the plan. The amount they would receive would be designated in the retirement plan documents. However, if the disability was severe and they couldn't work, they would receive 100 percent of their account balance in the retirement plan.

Can the tax-free 105(c) benefits be used for retirement payments?

No, the plan documents must make it impossible for the disability payments to be made for any purpose other than providing disability payments. Thus any money paid under Section 105(c) can't be moved to an IRA or another retirement plan.

Can the 105(c) benefits be used for a client's family?

Yes, any disability that a client suffers or any disfigurement they, their spouse or dependents incur can be paid tax-free from the retirement plan under 105(c).
What if a client can't work at their job, but can still do other things like light office work?
Benefits under Section 105(c) apply to the client's job. Thus, if their disability prevented them from being a doctor, but they could teach at a local college, they would still qualify under Section105(c).

What are the qualification requirements? Can an employer discriminate?

No, employers may not discriminate. All full-time employees, those working 20 hours per week or more, will need to benefit under Section 105(c).

How much can be contributed to a 105(c) account?
The 105(c) is a benefit under the retirement plan and not an insurance policy or separate account. Thus the normal contribution maximums under a retirement plan still apply. Any vested money in the retirement plan, including rollovers from other retirement plans or IRAs, would be paid to the participant tax free under Section 105(c) if the participant had a qualifying disability.

Why should a client have a 105(c) account in their retirement plan?

At least 51 million working adults in the United States are without disability insurance other than the basic coverage available through Social Security. Only 48 percent of American adults have an emergency fund to cover three months of living expenses. More than one in four Americans can expect to be out of work for at least a year due to a disability. A 105(c) account can offer a client the ability to tap into their retirement savings tax free if they have suffered a disability.

I have never heard of 105(c). Who else has a plan design like this?

The National Football League started a retirement plan for players in 1963. In 1976, the plan was amended to provide disability benefits. The IRS puts the information out there and there are plenty of court cases that can researched. IRS Publication 794 specifically mentions that a retirement plan can be an accident and health plans under Code Section 106. However, for the most part 105(c) and Section 106 have been ignored, largely due to the fact that people just don't read the fine print.

Can a Section 105(c) be added to an existing defined benefit plan or 401(k)?

Yes, it can be added to any 401(k), profit-sharing plan, money purchase plan or defined benefit plan. The current plan would need to be amended to incorporate the proper language. Without the required language, all distributions from a retirement plan are taxable.

What if a client is already disabled? Can it still be added to their retirement plan?

Yes, they can. There are no pre-existing conditions under Section 105(c). As long as they are still working, they can add Section 105(c) to their plan. Five to 10 percent of all cancer cases occur in someone who inherited a genetic mutation that increases cancer risk. About 50 percent of those who are 75 and older have disabling hearing loss and, 6.5 million Americans over age 65 have a severe visual impairment. Cancer treatments or a loss of hearing or eyesight could prevent a client from working, and they would then be able to withdraw from their retirement account under Section 105(c).

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