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Surplus Assets Locked in §401(h) Accounts — Is There a Key?

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Over 50 years ago Congress enacted a rather obscure provision in the Internal Revenue Code. Section 401(h), as amended, allows pension plan sponsors to set aside a limited amount of funds in a separate account within the pension plan. These funds may only be used to fund post-retirement medical benefits. In general, §401(h) permits a plan sponsor to set aside up to 25% of its total annual pension plan contributions in a §401(h) account. The §401(h) account funds are subject to the same favorable tax rules that apply to assets set aside for pensions, i.e., contributions to the §401(h) account are deductible when made and grow on a tax-free basis.

Over the years since the passage of §401(h), many large employers have chosen to take advantage of the tax savings available to them and set aside funds in §401(h) accounts. In many cases, however, and for various reasons specific to the facts and circumstances of each employer's individual workforce and financial situation, many employers have never actually used the funds to pay for retirees' medical benefits. Two common reasons that §401(h) account funds remained unused are: (1) employers preferred to use the account assets to offset other post-employment benefits (''OPEB'') liabilities on their financial statements and (2) the tax treatment of the funds, specifically the tax-free growth of account assets, is so favorable. Meanwhile, for reasons unrelated to §401(h), the trend has been for employers to decrease their OPEB liabilities. Taken together the result has been that many employers' §401(h) accounts are now significantly overfunded.

Section 401(h) account overfunding has given rise to numerous issues for employers that have such accounts. Recent developments in financial accounting also have had a great effect on plan sponsors with §401(h) accounts. As discussed in more detail below, we recommend that plan sponsors with §401(h) accounts work with legal counsel to identify reasonable approaches to maximize the use of §401(h) account assets consistent with the limited guidance currently available.

BACKGROUND

Section 401(h) Statute and Regulations

Generally, a qualified pension trust must ensure that it is impossible for any part of the trust to be used for, or diverted to, purposes other than the exclusive benefit of employees or their beneficiaries.[1] There is an exception, however, for funds in the trust that are allocated to provide medical benefits under §401(h).[2] The §401(h) assets in a qualified trust must provide for sickness, accident, hospitalization and medical expenses of retired participants and their spouses and dependents and must not be used for the retirement benefits of participants and beneficiaries.[3] Such medical benefits must be subordinate to the retirement benefits provided by the pension plan.[4]

As long as an individual has earned pension benefits under the plan and has retired from active employment, his or her retiree health benefits can be funded through a §401(h) account, even if the pension

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[1] Reg. §1.401-2(a)(l). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[2] §401(h); Reg. §1.401-14(a).

[3] §401(h).

[4] §401(h)(l).

benefit has been paid out through a lump sum or otherwise settled prior to payments being made under the §401(h) account.[5] Separate accounts must be established and maintained for key employees (and their spouses and dependents), and benefits paid to such individuals may only be paid from the separate account.[6]

The contributions for medical benefits funded through the §401(h) account must be ''reasonable'' and ''ascertainable,'' and the associated pension plan must contain provisions for determining the amount of medical benefits that will be paid. In practice this means that the associated pension plan must specify the amount of benefits and the time period with respect to which benefits will be paid.[7] Where there are other potential sources of payment of medical benefits, such as a welfare benefit fund or the general funds of the employer, the associated pension plan must be specific as to how the benefits payable from the §401(h) account are coordinated with benefits payable from other sources.[8] The plan generally may not allow for employer discretion in the timing and amount of benefit payments.[9]

The assets in a §401(h) account cannot be used for any purpose other than providing medical benefits until all of the liabilities for providing medical benefits are satisfied.[10] Once the medical benefit liabilities are satisfied, any amount remaining in the §401(h) account must be returned to the employer (an employer ''reversion,'' described below).[11] If any §401(h) account assets are used for retirement benefits (or any other purpose) before all of the medical benefit liabilities have been satisfied, the plan does not satisfy the requirements of §401(h) and the pension plan will not be a qualified plan under §401(a) — with all of the resultant adverse tax consequences.[12]

Section 4980 generally imposes a 50% excise tax on an employer reversion from a qualified pension plan.[13] An employer reversion is defined as the ''amount of cash and fair market value of other property received (directly or indirectly) by an employer from the qualified plan.''[14] There are three main exceptions to the imposition of the excise tax: (1) for amounts that could be distributed before termination of the plan without violating any provision of §401; (2) for certain amounts that are allowed to be returned to an employer under §401(a)(2); and (3) for certain transfers of §420 amounts back to the pension portion of the trust to support the funded status of a qualified plan.[15] Specifically, under the third exception, if a §420 transfer to a §401(h) account is a ''qualified future transfer'' (described below), the §401(h) assets may be returned to the pension plan if needed to preserve the pension plan's funded status at 120% of pension liabilities without any excise tax.

Nothing in the Code or the legislative histories of §401(h) and §4980 provide that the reversion excise tax applies to amounts contributed by the employer to, or reversions from, §401(h) accounts. This is in stark contrast to §420, which states that if amounts contributed in a §420 transfer do not qualify for the third exemption listed in the previous paragraph, any amount not used for medical benefits under the §401(h) account is subject to the excise tax on employer reversions.[16] There is no specific statutory provision imposing the excise tax on amounts in a §401(h) account that were not funded with a §420 transfer.

OPEB Liabilities

The liabilities for OPEBs, which include medical benefits, have become more heavily scrutinized since the Financial Accounting Standards Board (''FASB'') and the Governmental Accounting Standards Board (''GASB'') required that employers recognize their liabilities under generally accepted accounting principles. OPEBs, the term that generally refers to non-pension retirement benefits, must be reported by private companies under FASB Accounting Standards Codification 715-60 and by governments under GASB Statement No. 75. In many cases, OPEB liabilities represent significant liabilities on employers' financial statements.

One way to offset the adverse impact of OPEB liabilities is to set aside assets, typically in a trust, to prefund the liabilities. The prefunded assets offset the reported OPEB liabilities, and the investment earnings on those assets offset the annual reported OPEB expense. Prefunding OPEB liabilities can also help maintain a stable budget because the accumulated assets can be used if there are higher cash requirements to provide benefits in a particular year. The FASB and GASB standards have trended toward greater disclosure of OPEB liabilities; thus, if an employer offers OPEB benefits to its retirees, it may be advantageous to use a prefunding vehicle, such as a trust.

In the past, accounting professionals have had trouble determining which plan should report the §401(h) account assets. On one hand, the pension plan holds the assets in a separate account within its trust. On the other hand, the retiree medical plan provides for the benefits that are funded with the §401(h) account assets. In AICPA Opinion 99-2, the accounting authorities concluded that the §401(h) assets should be reported on the retiree medical plan's financial

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[5] PLR 201511044.

[6] §401(h)(6). A key employee is an employee who, at any time during the plan year, is generally: (1) an officer of the employer with annual compensation over $170,000 (for 2016); (2) a 5% or more owner of the employer; or (3) a 1% or more owner of the employer with annual compensation over $150,000.

[7] §401(h)(3); Reg. §1.401-14(c)(1)(i) and §1.401-14(c)(3).

[8] Reg. §1.401-14(c)(1)(i).

[9] §401(h)(4).

[10] §401(h)(4); Reg. §1.401-14(c)(4).

[11] §401(h)(5); Reg. §1.401-14(c)(5).

[12] Reg. §1.401-14(c)(4); GCM 39785 (Apr. 3, 1989).

[13] §4980(a) and §4980(d)(l).

[14] §4980(c)(2)(A).

[15] §4980(c)(2)(B); §420(f)(2)(B)(ii)(II).

[16] §420(c)(1)(B)(ii)(II).

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statements, along with the liabilities as a single line item or a presentation. This was the case even though the assets are reported on the pension plan's Form 5500 (although it was recommended that the pension plan's footnotes indicate that the §401(h) assets may not be used to satisfy pension liabilities). In June 2016, FASB released an Exposure Draft that tentatively proposed that the medical plan not be required to provide any investment disclosures for §401(h) accounts, which would eliminate duplicative footnote disclosures in the statements for both the pension plan and the medical plan. However, the medical plan should disclose the name of the pension plan so that users can access the specific information related to the §401(h) accounts on the pension plan's Form 5500.

Section 4980 Excise Tax

As stated above, §4980 generally imposes a 50% excise tax on the amount of any employer reversion from a qualified plan. Plans maintained by tax-exempt employers and §414(d) governmental plans are exempt from the tax.[17] When §401(h) was enacted, this excise tax did not exist, and a §401(h) reversion would only have been subject to income tax. As explained below, when Congress later added §4980, the 50% excise tax was intended to deter employers from voluntarily terminating the pension plan prematurely in order to recover its assets and use them for other corporate purposes. Thus, Congress provided that, if an employer allocates 20% of the reversion to provide increased pension benefits, or allocates 25% of the reversion into a ''qualified replacement plan,'' the excise tax can be reduced to 20%.[18] In addition, if the employer allocates the entire reversion into a ''qualified replacement plan,'' the amount is not subject to the §4980 reversion tax or income tax.[19] However, none of these ways to reduce the excise tax appear to apply to excess §401(h) assets because those assets must revert to the employer under §401(h)(5).

Section 420 Transfers

Besides employer contributions to a §401(h) account, §420 provides an additional tool to fund §401(h) accounts. Employers with overfunded pension plans may, with certain limitations, transfer excess pension assets over to a §401(h) account to prefund retiree medical benefits in a §420 transfer. The investment earnings in the §401(h) account can reduce the annual OPEB accounting expense for these benefits.

The Code specifically provides that a §420 transfer will not: (1) cause a pension plan to be disqualified; (2) cause the pension plan to fail to satisfy the §401(h) requirements; (3) create a reversion under §4980; or (4) cause a prohibited transaction within the meaning of §4975.[20] However, several requirements must be met to satisfy the §420 rules. To be a ''qualified transfer'' under §420 with respect to medical benefits, the amount of the transfer must reflect one year of medical benefits.[21] Alternatively, a ''qualified future transfer'' can reflect up to 10 years' of medical benefits.[22] A summary of the ''qualified transfer'' requirements with respect to medical benefits (without regard to certain special rules for collectively bargained plans) is provided below:

- *Overfunded Pension Plan:* The pension plan must generally be 125% funded, determined without regard to the smoothed interest rates provided under the 2012 ''MAP-21'' legislation and the Highway and Transportation Funding Act of 2014 (''HATFA'').[23] If the plan is merged with another plan, the combined funded level needs be at 125%. Note that the assets transferred in a §420 transfer are not included for determining a plan's required funding contribution once the transfer has been made.

- *Maximum transfer amount:* A plan cannot transfer any amount that is greater than what is reasonably estimated for the employer to pay (directly or through reimbursement) for medical benefits during the taxable year of the transfer.[24]

- *Use Requirement:* The transferred assets must be used to pay for medical benefits for non-key employees only.[25] If the transferred amount is not used for these purposes, it must be transferred back to the pension plan and will be subject to the §4980 excise tax.[26]

- *Minimum Cost Requirement:* The per-participant cost for each medical plan, over the current and next four taxable years, cannot be less than the higher of the employer costs for such insurance in each of the prior two years.[27] In addition, an employer cannot significantly reduce medical benefits during the five-year period described in the previous sentence.[28]

- *Vesting Requirement:* All participants in the pension plan must be fully vested, including any participants who separated from employment during the one-year period ending on the date of the

[17] §414(c)(1).

[18] §4980(d).

[19] Rev. Rul. 2003-85, 2003-21 I.R.B. 291.

[20] §420(a).

[21] §420(b)(3).

[22] §420(f).

[23] §420(e)(2).

[24] §420(b)(3).

[25] §420(c)(1)(A) and §420(e)(1)(E).

[26] §420(c)(1)(B).

[27] §420(c)(3)(A).

[28] §420(c)(3)(D).

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§420 transfer.[29] However, the IRS has indicated that any future accruals after the transfer date can be subject to the vesting schedule.[30]

- *Only one transfer per year:* A plan can generally only transfer the pension assets once per year.[31]

A "qualified future transfer" can prefund up to 10 years of future medical benefits, but has the following additional/modified requirements:

- *Pension Plan Funding:* The pension plan must only be 120% funded, determined without regard to the HATFA and MAP-21 smoothed interest rates.[32] However, if the pension plan falls below 120% funded, either (1) the employer must make a contribution to the pension plan to reach the 120% level, or (2) assets must be transferred back to the pension plan so that the pension plan is 120% funded.[33] If assets must be transferred back to the pension plan due to a drop in the funding status, they are not considered reversions subject to the excise tax under §4980.[34]
- *Maximum Transfer Amount:* In a "qualified future transfer" the plan can transfer up to an amount reflecting the anticipated costs of medical benefits for up to a 10-year period.[35] However, if another §420 transfer is done in a later year within that "up to 10-year period," then the future limit is reduced by the amount of the previous transfer.[36]
- *Minimum Cost Requirement:* For a "qualified future transfer," there are two options. One is that the plan could satisfy the minimum cost requirement for a "qualified transfer" above, but would need to do so for up to 14 years instead of five.[37] Alternatively, the plan could elect to provide substantially the same level of applicable medical benefits as existed for the year immediately prior to the transfer for each tax year for up to 14 years after the transfer.[38]

These requirements limit the number of pension plans that are able to take advantage of a §420 transfer. For the employers that are able to use it, however, a §420 transfer can help reduce the annual OPEB expense for accounting purposes and can generate more steady contributions to fund medical benefits.

[29] §420(c)(2).

[30] 2009 Enrolled Actuaries Meeting, Grey Book, Q&A-42.

[31] §420(b)(2).

[32] §420(f)(2)(B)(i).

[33] §420(f)(2)(B)(ii).

[34] §420(c)(1)(B).

[35] §420(f)(5).

[36] §420(f)(3).

[37] §420(f)(2)(D)(i).

[38] §420(f)(2)(D)(ii).

OVERFUNDED §401(h) ACCOUNTS

Reasons for Overfunded Accounts

One reason employers may have overfunded §401(h) accounts is that the §401(h) account assets have generated significant investment gains such that the assets exceed the amounts required to satisfy the §401(h) benefit liabilities. A more common reason, however, is that employers' OPEB liabilities have decreased significantly, such as through declining work forces, benefit reductions and conversion to defined contribution-type accounts. These defined contribution-type accounts are typically health reimbursement arrangements ("HRAs") that retirees can use to buy coverage on private exchanges designed for this purpose and to reimburse other medical expenses — for example, an HRA that Medicare-eligible retirees can use to purchase Medicare supplemental products.

Although practitioners have generally thought it was permissible for §401(h) accounts to fund HRAs, it was not until March 11, 2016, that the IRS provided written guidance on this issue in the form of a Private Letter Ruling ("PLR").[39] Specifically, in PLR 201611003, the IRS ruled that the use of a §401(h) account to reimburse certain retirees covered under the pension plan for eligible medical insurance premiums under an HRA plan will not violate §401(h) or cause the pension plan to lose its qualified status (note, however, that one key fact that the IRS seemed to rely on is that the §401(h) account was not funded by a §420 transfer).[40] Although a PLR does not provide guidance of general applicability — it is only binding on the particular taxpayer to whom it is issued — it does provide insight into how the IRS views the issue.[41]

Unresolved Issues Surrounding Overfunded Accounts

As stated above, when there are excess §401(h) account assets, §401(h)(5) requires that the excess be returned to the employer after all medical benefit liabilities are satisfied. The legislative history of §401(h) explains the rationale for requiring the return of §401(h) account assets on plan termination. Specifically, Congress was concerned that employers might overfund §401(h) accounts as a way to indirectly avoid the §404(a) limits on pension contributions.[42] Further, when §401(h) was enacted in 1962, the §4980 excise tax on reversions did not yet exist.

The §4980 excise tax on employer reversions applies to amounts received, directly or indirectly, by an employer from a qualified plan. The legislative history does not indicate whether the §4980 excise tax applies

[39] *See* PLR 201611003.

[40] *Id.*

[41] §6110(k)(3).

[42] *See* H. Rep. No. 2317, 8th Cong. 2d Sess. at p. 3 (Aug. 31, 1962).

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to employer reversions from an overfunded §401(h) account. Indeed, the entire legislative history behind §4980 focuses on employer pension plan terminations, which was a major area of concern at the time. For example, the General Explanation of the Tax Reform Act of 1986 (at page 751) states:

> Congress believed that it was appropriate to limit the tax incentives available for retirement savings provided through defined benefit pension plans to the amount actually applied to provide retirement income. To the extent that amounts in such plans are not used for retirement purposes and revert to an employer, Congress believed that the tax treatment of reversions should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this tax treatment should be recaptured.[43]

Notwithstanding that it seems inequitable to apply a punitive tax to a transfer that is required by the Code, and that the Code does not explicitly state that the mandatory reversion would be subject to §4980, the IRS has indicated that the excise tax does apply to §401(h) assets that revert to the employer.[44]

Some employers might consider using the excess §401(h) assets to fund liabilities under the pension plan. Apart from the §401(h) regulations themselves, however, and a few PLRs, there is very little guidance addressing §401(h) accounts. As stated above, the longstanding §401(h) regulations make it clear that §401(h) account funds must be used to pay retiree *medical* benefits of eligible pensioners, and they cannot be ''repurposed'' to fund pension liabilities (or any other benefits). If funds are repurposed, the pension plan could be disqualified and the employer may be deemed to receive a taxable reversion (which, as discussed above, may also trigger a 50% excise tax). Thus, employers are severely limited with respect to permissible ways to deal with overfunded §401(h) accounts.

Additionally, the IRS would likely not allow the transfer of §401(h) account money outside the pension plan, except to another §401(h) account.[45] Some employers have considered whether they could move the §401(h) account funds to a voluntary employees' beneficiary association (''VEBA'') to fund other medical and welfare benefits. While GCM 39785 makes it clear that a VEBA cannot transfer funds to a §401(h) account, it is not entirely clear whether the converse is true, i.e., whether §401(h) account funds may be transferred to a VEBA. It is possible that the IRS could apply similar reasoning to prohibit a transfer from a §401(h) account to a VEBA (that the VEBA rules prohibit a reversion to the employer, but the §401(h) rules require it), although there is no authority on the issue.

The IRS has recently ruled that a governmental entity can transfer excess §401(h) account money outside the pension plan to a §115 trust (a type of trust some governmental entities use to fund medical benefits). In PLR 201625005, a state public employees' retirement system funded retiree medical benefits to retirees in its pension plan through a §401(h) account. The system was terminating its current retiree medical plans and creating new retiree medical plans, including an HRA plan. As part of the termination, the assets of the §401(h) account would first revert to the system, and then the system would transfer the §401(h) account assets to a §115 trust. The IRS ruled that the return of the §401(h) account assets to the system would not jeopardize the qualified status of the pension plan. The IRS also ruled that the reversion would not be subject the system to the §4980 excise tax under the exception to the excise tax for §414(d) governmental plans.[46]

''Orphan'' §401(h) Accounts

It has become increasingly common for the §401(h) account to become overfunded. This becomes a problem if the employer terminates the associated pension plan because, when the associated pension plan is terminated, the §401(h) account would still have assets even after satisfying all medical plan liabilities. There is no authority on whether the §401(h) account may continue on a stand-alone basis as an ''orphan'' account in the event some medical plan liabilities still exist after the pension plan terminates. Thus, it is unclear what happens to a §401(h) account when the employer terminates the pension plan.

If the assets must revert to the employer in this situation, as is seemingly required by §401(h)(5), both income tax and the §4980 excise tax may apply, which would effectively use up most of the surplus. Without any guidance on orphan accounts, and without any alternatives to avoid the severe taxes imposed on the legally-required reversion, employers should be careful when terminating a pension plan with an overfunded §401(h) account.

CONCLUSION

At this point, there do not appear to be any clear solutions to the issues presented by overfunded §401(h) accounts. Although Congress has allowed overfunded pension plans to use surplus pension assets to pay retiree medical (and life insurance) benefits on a tax-free basis by moving the excess pension funds to §401(h) accounts through a §420 transfer, there does not seem to currently be an ability to use overfunded §401(h) accounts for any other purposes, except in the limited cases of tax-exempt employers and governmental plans. Thus, employers with overfunded §401(h) accounts would be well-advised to

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[43] Staff of Joint Comm. on Taxation, JCS-10-87, General Explanation of the Tax Reform Act of 1986, at 751 (May 4, 1987).

[44] *See* PLR 201625005.

[45] *See, e.g.,* PLR 201611003.

[46] *See* §4980(a)(1)(B).

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spend down their §401(h) account assets to pay retiree medical benefits while they still have outstanding liabilities and should consider the funding status of the §401(h) account when considering transitioning from comprehensive retiree medical benefits to HRA-type benefits. Congress may also wish to reexamine this issue — either in the context of comprehensive tax reform or as a stand-alone item — so that employers without significant retiree medical liabilities are not left with the draconian choice of leaving significant assets unspent or subject to a 50% excise tax.

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