

Publications

IRS Rules That Payment of 401(h) Account Benefits to Pension-Eligible Active Participants Won't Jeopardize Plan Qualification

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PUBLISHED

02/21/2023

SOURCE

Groom Publication

SERVICES

Employers & Sponsors

- Health & Welfare Programs

Health Services

- Taxation of Benefits

A recent IRS letter ruling provides helpful clarification on the interaction of in-service distributions to active employees (Code section 401(a)(36)) and the requirement that Code section 401(h) accounts provide only retiree medical benefits. We summarize the ruling below.

Background

A 401(h) account allows an employer to fund retirees' "qualified medical expenses" through defined benefit or money purchase plans, if certain conditions are satisfied. A qualified medical expense is defined as a payment made for "sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents." Treas. Reg section 1.401-14 further provides conditions that must be satisfied to preserve the retirement plan's tax-qualified status under Code section 401(a), including maintaining separate accounts, specifying the benefit terms, and complying with a "subordination" requirement. Since the addition of Code section 401(h) in 1962, and the subsequent publication of corresponding treasury regulations, the IRS has offered little guidance on the design and administration of Code section 401(h) accounts.

Qualified pension plans are subject to longstanding requirements that they pay benefits only to retired employees. Treas. Reg. § 1.401-1(b)(1)(i). However, under recent changes to the Code (Code section 401(a)(36)), distributions may be made to an employee who has reached age 59½ even though he/she is still working.

The Ruling

On February 3, 2023, the IRS released [PLR 202305001](#), which addresses whether retiree medical distributions from a 401(h) account would cause the qualified pension plan to lose its qualified status. In the PLR the plan was amended in accordance with Code section 401(a)(36) to permit distributions to active employees upon their attainment of age 59½. The qualification concern arises under the Treas. Reg section 1.401-14(b)(1) requirement that a 401(h) account only pay medical expenses of "retired" employees, their spouses, or their dependents.

The PLR ruled that the plan would not lose its qualified status because the 401(a)(36)-eligible active participants are eligible to receive pension benefits and, therefore, meet the definition of “retired employees” under the terms of the plan. However, the IRS noted that, if instead separation from employment was a condition to receiving pension benefits under the plan, the individual would not be “retired” for 401(h) account purposes. And, in that case, the 401(h) account could not pay the medical expenses of such an individual while still employed. Thus, whether a 401(h) account can pay medical expenses for a particular individual turns on the plan provisions.

While only the recipient of this PLR may rely on the ruling, this gives insight into IRS’s current thinking on the administration of 401(h) account benefits under the increasingly popular provision for in-service pension distributions.