

Publications

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 in the attached article, 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. Please see the attached article for further information.