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Current Issues Affecting Pension Plan 401(h) Accounts

A. Background

Over 50 years ago, Congress enacted a rather obscure provision (Code sec. 401(h)) that allowed pension plan sponsors to set aside a limited amount of funds in a separate account to fund post-retirement medical benefits within the pension plan. In general, the plan sponsor could set aside up to 25% of its total annual plan contributions in the 401(h) account under the same favorable tax rules as applied to assets set aside for pensions, *i.e.*, the contributions are currently deductible and grow on a tax-free basis.

Over the years, many large employers have set aside funds in 401(h) accounts. In many cases, employers have chosen not to use the funds to pay retirees' medical benefits – perhaps because they prefer to use the assets to offset “OPEB” (“other post-employment benefits”) liabilities on their financial statements and because the tax treatment is so attractive. Meanwhile, employers have whittled down their “OPEB” liabilities through declining work forces, benefit reductions, conversion to defined contribution-type accounts (“health reimbursement accounts”) that retirees can use to buy coverage on private exchanges designed for this purpose, etc. The bottom line is that many employers' 401(h) accounts are now overfunded.

Section 401(h) account overfunding has given rise to numerous issues for plan sponsors that have such accounts. Recent developments in financial accounting may affect plan sponsors with 401(h) accounts, too. We briefly discuss both topics below, and recommend that affected plan sponsors work with legal counsel to identify reasonable approaches to maximize the use of 401(h) account assets consistent with the limited guidance currently available.

B. Unresolved Issues Surrounding Overfunded 401(h) Accounts

Apart from the IRS regulations themselves and a few private letter rulings, there is very little guidance in the 401(h) area.

- Longstanding IRS rules (Treas. Reg. § 1.401-14) make it clear that 401(h) funds must be used to pay retiree medical benefits of eligible pensioners – they cannot be “repurposed” to fund pension liabilities (or any other benefits). If they are, the pension plan could be disqualified and the employer may be deemed to receive a taxable reversion (which, as discussed below, may also trigger a 50% excise tax).

- IRS would likely not allow the transfer of 401(h) money outside the pension plan, except to another 401(h) account. Thus, for example, it is unclear if 401(h) funds can be moved to a VEBA where they could fund other medical and welfare benefits. IRS GCM 39785 (1989) makes it clear that a VEBA cannot transfer funds to a 401(h) account – IRS could apply similar reasoning to prohibit a transfer in the other direction, although there is no authority on the issue.
- It is unclear what happens to a 401(h) account when the pension plan is terminated. There is no authority on whether an “orphan” 401(h) account is even permitted or whether transfers to other pension plans are allowed. If not, the amounts must revert to the employer who will be faced with both income tax and the 50% reversion tax (Code sec. 4980) – effectively using up most of the surplus. (Recent PLR 201625005 implies the reversion tax applies to 401(h) amounts, though it was issued to a governmental plan exempt from the reversion tax.)
- Subject to detailed rules – liberalized in the 2006 Pension Protection Act and again in the 2012 “MAP-21” legislation – Congress has allowed very 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 (Code sec. 420). But there is no current ability to use overfunded 401(h) assets for any other purpose.

At this point, there do not appear to be any clear solutions to these issues. Thus, employers would be well advised to spend down their 401(h) account assets to pay retiree medical benefits while they still have outstanding liabilities.

C. Proposed FASB Change to Accounting for 401(h) Assets

Over the years, accounting professionals have had trouble figuring out which plan’s financial statements should report the 401(h) account assets – the pension plan that holds the assets in a separate account that cannot be used to pay pension benefits, or the retiree health plan providing for the benefits funded with 401(h) account assets. Briefly summarized –

- For many years, there was no authoritative guidance on which plan should report the assets. However, most of the major accounting firms favored reporting on the pension plan’s financial statements.
- In AICPA Opinion 99-2, the accounting authorities concluded that the 401(h) assets should be reported on the financial statements of the retiree health plan, along with the liabilities as a single line item or a broad presentation. This is the case even though the assets are reported on the pension plan is Form 5500. The opinion recommended that the pension plan’s footnotes indicate that the 401(h) assets may not be used to support pension liabilities.

This past June, in an Exposure draft dealing with various master trust reporting issues, FASB tentatively proposed that the health and welfare benefit plan not be required to provide any investment disclosures for 401(h) accounts. This would eliminate duplicative footnote disclosures in the statements for both plans. However, the retiree health plan statement should disclose the name of the defined benefit pension plan so that users can access the specific information relating to the 401(h) accounts if desired.

Whether FASB has resolved all of the accounting issues for 401(h) accounts remains to be seen. Comments on Proposed Accounting Standards Update (issued July 28, 2016) are due by September 26.