

## **Frequently Asked Questions on the 401(h) Benefit**

### **What is a *medical expense account* under Code Section 401(h)?**

A *medical expense account* under Code Section 401(h) is an account within a defined benefit pension plan for the payment of the sickness, accident, hospitalization, and medical expenses of retired employees and the spouses and dependents of retired employees. [Treas. Reg. §1.401-14(a)] The term *retired* for purposes of eligibility to receive medical benefits under Code Section 401(h) means that the employee is eligible to receive retirement benefits under the plan or is treated as retired by the employer by reason of the employee's permanent disability. An employee who must terminate employment with the employer as a condition of receiving retirement benefits is not considered retired. [Treas. Reg. §1.401-14(b)(1)]

### **What requirements must a plan satisfy with respect to a Section 401(h) arrangement?**

A plan must satisfy the following requirements with respect to a Section 401(h) arrangement:

*Nondiscrimination.* A Section 401(h) arrangement cannot discriminate in favor of officers, shareholders, supervisory employees, or HCEs with respect to coverage or with respect to contributions and benefits. The determination of whether a Section 401(h) arrangement so discriminates is made with reference to the retirement portion of the defined benefit plan as well as the Section 401(h) arrangement. [Treas. Reg. §1.401-14(b)(2)]

*Benefits.* A Section 401(h) arrangement must specify the medical benefits that will be available and must contain provisions for determining the amount that will be paid. Furthermore, such benefits, when added to any life insurance protection provided under the defined benefit plan, must be subordinate to the retirement benefits provided by the plan. [Treas. Reg. §1.401-14(c)(1)]

*Separate account.* A separate account must be established for the contributions used to fund the Section 401(h) benefits. The separation is for recordkeeping purposes only; therefore, the plan can invest the contributions to the 401(h) account in the same manner as it invests funds used to provide retirement benefits. [Treas. Reg. §1.401-14(c)(2)]

*Reasonable and ascertainable contributions.* The contributions to fund medical benefits must be reasonable and ascertainable. The employer must, at the time it makes a contribution, designate the portion of the contribution allocable to funding medical benefits. [Treas. Reg. §1.401-14(c)(3)]

*Impossibility of diversion prior to satisfaction of all liabilities.* It must be impossible at any time prior to the satisfaction of all liabilities under the plan for any part of the corpus or income of the medical benefits account to be used for, or diverted to, any purpose other than providing medical benefits under the plan. The payment of necessary or appropriate expenses attributable to the administration of the medical benefits account, however, does not affect the qualification of the plan. [Treas. Reg. §1.401-14(c)(4)]

*Reversion on satisfaction of all liabilities.* The plan must provide that any amounts that are contributed to fund the 401(h) account and that remain in the account after satisfaction of all liabilities arising out of the operation of the Section 401(h) arrangement are returned to the employer. [Treas. Reg. §1.401-14(c)(5)]

*Forfeiture.* The plan must expressly provide that if an individual's interest in the medical benefits account is forfeited prior to termination of the plan, an amount equal to the amount of the forfeiture will be applied as soon as administratively possible to reduce employer contributions to fund the 401(h) account. [Treas. Reg. §1.401-14(c)(6)]

### **When are benefits provided under a Section 401(h) arrangement considered subordinate to retirement benefits?**

The medical benefits provided under a [Section 401\(h\)](#) arrangement are considered subordinate to the plan's retirement benefits if at all times the aggregate contributions made to provide the medical benefits and any life insurance protection do not exceed 25 percent of the aggregate contributions (made after the date that the plan first includes the medical benefits) exclusive of contributions to fund past-service credits. [[Treas. Reg. §1.401-14\(c\)\(1\)\(i\)](#)]

**Example:**

The Landscaping and Rock Company amended its defined benefit pension plan to provide medical benefits as described in [Code Section 401\(h\)](#) effective for the 2000 plan year. The total contributions under the plan (excluding those for past-service credits) for the 2000 plan year are \$125,000, of which \$100,000 is for retirement benefits, \$10,000 for life insurance, and \$15,000 for medical benefits. The medical benefits described in [Code Section 401\(h\)](#) are considered subordinate to the retirement benefits because the portion of the contributions allocated to the medical benefits (\$15,000) and to life insurance (\$10,000), or \$25,000, does not exceed 25 percent of \$125,000.

For the 2001 plan year, the company contributes \$140,000 (exclusive of past-service credits), of which \$100,000 is for retirement benefits, \$10,000 for life insurance protection, and \$30,000 for medical benefits. The medical benefits described in [Code Section 401\(h\)](#) are still considered subordinate to the retirement benefits because the aggregate contributions allocated to the medical benefits (\$45,000) and to life insurance (\$20,000), or \$65,000, do not exceed 25 percent of \$265,000, the aggregate contributions made in 2000 and 2001.

**Can excess assets in a defined benefit plan be used to fund medical benefits described in Code Section 401(h)?**

Yes. Employers are permitted to transfer excess assets from a defined benefit plan to an account for the payment of medical benefits described in [Code Section 401\(h\)](#). A plan is deemed to have excess assets for this purpose if assets exceed 125 percent of the plan's current liability. In addition, there are several rules that must be followed:

1. The transferred amount can be used to pay medical benefits for either the year of the transfer or the year of transfer and the future transfer period, called a qualified future transfer.
2. The transferred amount must approximate the amount of medical expenses anticipated for the year of transfer or the year of transfer and future years during the transfer period.
3. An employer can make only one such transfer in a year.
4. All accrued benefits of participants in the defined benefit plan must be fully vested.
5. The employer must commit to a "maintenance of effort" requirement with respect to the medical benefits.

**[[I.R.C. §420](#)]**

This provision that allows for the transfer of excess assets to a 401(h) account is set to expire on December 31, 2013. [[I.R.C. §420\(b\)](#), as amended by the Pension Funding Equity Act of 2004]

For plan year beginning after December 31, 2006, multiemployer plans may also transfer excess pension assets to 401(h) accounts, subject to the same rules as single employer plans. [[I.R.C. §420\(e\)\(5\)](#)]

## How are the excess assets determined?

The term *excess pension assets* means the excess (if any) of --

(A) the lesser of --

- (i) the fair market value of the plan's assets (reduced by the prefunding balance and funding standard carryover balance determined under Code Section 430(f)), or
- (ii) the value of plan assets as determined under Code Section 430(g)(3) after reduction under Code Section 430(f), over

(B) 125 percent of the sum of the funding target and the target normal cost determined under Code Section 430 for such plan year.

[I.R.C. §420(e)(2)(B)]

## What is a qualified future transfer?

In lieu of a regular qualified transfer during a tax year, an employer may elect to make a qualified future transfer. A qualified future transfer is equal to the sum of:

1. If the transfer period includes the taxable year of the transfer, the amount determined under a regular qualified transfer (as determined under Code Section 420(b)(3)) for such taxable year; and
2. In the case of all other taxable years in the transfer period, the sum of the qualified current retiree health liabilities which the plan reasonably estimates (to be determined in accordance with guidance yet to be issued) will be incurred for each of such years.

[I.R.C. §420(f)(2)(C)]

The qualified future transfer may transfer excess pension assets from the defined benefit plan to the 401(h) account based on the plan being funded with assets equal to at least 120 percent of current liability rather than a 125 percent of current liability level as required for regular qualified transfers. [I.R.C. §420(f)(2)(B)(i)] However, the sponsor must also track the funded status of the defined benefit plan during the transfer period and if the current liability ever drops below the 120 percent funded level as of any valuation date during the transfer period, then the employer must either (1) contribute additional funds to the defined benefit plan in order to increase the assets above the 120 percent of current liability, or (2) transfer funds back to the defined benefit plan from the 401(h) account. [I.R.C. §420(f)(2)(B)(ii)]

Except as stated above, a qualified future transfer must meet all the other requirements applicable to regular qualified transfers.

## What is a *transfer period*?

The *transfer period* means, with respect to any transfer, a period of consecutive taxable years (not less than two) specified in the qualified future transfer election which begins and ends during the 10-taxable-year period beginning with the taxable year of the transfer.

## Sample List **401(h) Benefits** Pension Benefit Plan & Trust

Below is a *sample* list of post-retirement medical benefits that may be provided under a

### **401(h) Benefit Option**

Benefits are not limited to those contained in this list.

Acupuncture	Hospitalization Insurance
ADD Counseling and Assistance	Hospital Bills
Air Lift Transportation (Both US and Non US)	Insulin
Alcoholism	Laboratory Fees
Alternative Healthcare	Laetrile by Prescription
Alternative Medicines	Lasik Eye Surgery
Ambulance	Hire Lead Base Paid Removal-Children with Lead Poisoning
Artificial Limbs	Retirement Home for Medical Care
Artificial Teeth	Long Term Care, Nursing Homes
Assisted Living Facilities	Medical Information Plan
Asthma and Allergy Prevention and Treatment	Medicines
Birth Control Pills	Membership Fees for Medical Services, Hospitalization, Clinical Care, Health Maintenance, Health club memberships
Braces	Nurses Fees, Nurses Room and Board
Braille-Books and Magazines	Social Security Tax (Where Paid by Taxpayer)
Chiropractors	Obstetrical Expenses
Christian Science Practitioners' Fees	Operations (100% of All Costs)
Contact Lenses Including Examination Fee	Orthopedic Shoes
Co-Pays	Oxygen
Cosmetic Surgery (Even Though not by a Physician)	Personal Trainers
Cost for Care Outside the United States	Physical Therapy
Cost of Operations and Related Treatments	Physician Fees
Counseling	Premiums for LTC
Crutches	Preventive Care including but not limited to Spa Facilities, Usage Fees for Facilities
Deductibles	Prosthetics
Dental Cosmetic Surgery	Psychiatric Care
Dental Fees	Psychologist Fees
Dentures	"Seeing-eye" Dog and its Upkeep
Dependent Care	Specialists and Specialized Treatments
Dermatologist Care	Specially Equipped Cars
Diagnostic Fees	Special Care Costs for Disabled Dependents
Drugs	Special Diets
Electrolysis	Sterilization Fees
Experimental Care	Support Groups
Eyeglasses, Including Examination Fee, Laser Surgery for Vision Correction	Surgical Fees
Fees of Practical Nurse	Therapy Treatments
Fees for Healing Services	Transportation Expenses for Medical Services including Preventative Care
Fees of Chiropractors	Tuition Fee (part), if College or Private School Furnishes Breakdown of Medical Charges
Fees for Fitness Programs and Facilities	Tuition at Special School for Handicapped
Fees of Licensed Osteopaths	Viagra
Group Therapy	Vitamins
Handicap Persons' Special Schools	Wheelchair
Flu Shots	Weight Loss Programs
Hair Transplants	Wigs
Health Insurance Premiums	X-rays
Hearing Devices and Batteries	
Holistic Care	
Hospice	
In Home Care	