

Chapter 8 IRC SECTION 401(h) RETIREE MEDICAL BENEFITS

By Jay Jensen, Abba Rabbani
Cafeteria Plan Technical Advisors

and Jim Holland (Reviewer)
EMPLOYEE PLANS
TECHNICAL

With Ede Olsen
TE/GE Actuary

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I. Introduction

Section 401(h) of the Code permits a pension or annuity plan to provide for payment of benefits for sickness, accident, hospitalization and medical expenses for retired employees, their spouses and dependents. In order for the pension or annuity plan to meet the provisions of section 401(h), such medical benefits must be subordinate to pension benefits and must be established and maintained in a separate account.

Medical benefits provided in a pension plan are considered ancillary benefits. Some of the special requirements discussed herein are variations on the "incidental benefit" rules that have always been a concern for qualified pension plans. Thus, the contribution limitation described in section 401(h) is referred to as the "subordination limit," since its purpose is to insure that medical contributions are subordinate to the contributions for pension benefits. Failure to meet such requirements is a qualification issue for the pension plan of which the section 401(h) medical account is a part.

Anecdotal evidence suggests that employers sparingly utilized section 401(h) accounts prior to the 1990's. Employers primarily established voluntary employee beneficiary associations (VEBA's), as described in section 501(c)(9) of the Code, to fund and deduct contributions to provide post-retirement benefits including retiree health and life insurance.

Currently, many employers use both a VEBA and section 401(h) account to fund and deduct these benefits. Utilizing a section 401(h) account in conjunction with a VEBA permits employers to fund and deduct a greater amount of contributions than either arrangement would individually provide.

The importance of funding benefits in trusts such as VEBA trusts and section 401(h) accounts within a pension trust was heightened by the issuance of Statement of Financial Accounting Standard (SFAS) 106 which addresses employers' accounting for post-retirement benefits other than pensions. This Statement, issued in December of 1990, became mandatory for most employers for fiscal years beginning after December 15, 1992. SFAS 106 requires most employers to accrue the expected cost of post-retirement benefits other than pensions during the years that an employee renders services rather than on a pay-as-you-go basis.

SFAS 106 requires the current recognition of the future expense for financial accounting purposes, but does not require the actual funding of

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benefits. Expense recognition by the employer creates an unfunded liability on the employer's balance sheet.

Although SFAS 106 does not address the tax deduction allowable to the employer, this Statement may have an indirect effect on the amounts claimed as a deduction by giving employers an incentive to prefund larger amounts of post-retirement health and life insurance benefits than employers may have in the absence of the book accrual requirement.

This effect may occur because SFAS 106 permits an employer to offset the liabilities accrued on its balance sheet for post-retirement benefits by the amount of any assets that have been set apart from its general assets, e.g., in a section 401(h) account or a VEBA trust, and dedicated solely to the payment of those benefits.

The primary guidance with respect to section 401(h) accounts consists of:

- Code Section 401(h) (including corresponding Committee Reports),
- Code Section 420 (concerning transfer of assets to a 401(h) account),
- Treasury Regulation 1.401-14 (concerning qualification issues and the relationship between a pension plan and a section 401(h) medical account) and
- Treasury Regulation 1.404(a)-3(f) (concerning specific deduction issues).

Other available documents that may be of interest include IRS private letter rulings 9834037, issued May 28, 1998; 9709038, issued December 3, 1996 and 9652021, issued September 30, 1996. Of course, private letter rulings may not be cited by the Service or employers other than the specific employers who requested the rulings. Throughout this text, other relevant sources will also be discussed. Currently, case law does not exist relating to the deduction or qualification provisions of section 401(h) accounts.

II. Objectives

1. Identify section 401(h) retiree medical accounts.
2. Determine what should be considered when reviewing a determination letter application.

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3. Determine what should be considered when examining a pension or annuity plan.

III. Background

Section 401(h) of the Code was established and generally effective for taxable years beginning in 1963. This section was amended to add certain provisions effective for contributions made after October 3, 1989.

Section 1.401-1(b)(1)(i) of the Income Tax Regulations provides that a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of section 1.401-14).

Section 401(h) of the Code permits a pension or annuity plan to provide for payment of benefits for sickness, accident, hospitalization and medical expenses for retired employees, their spouses and dependents.

Accordingly, the exclusive method for providing medical benefits in a pension plan (or money purchase plan) is by utilizing a section 401(h) account.

Section 1.401-1(b)(1)(ii) of the Income Tax Regulations provides that a profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

Thus, a profit-sharing plan may provide for incidental accident or health insurance benefits. However, a section 401(h) account is not permitted in a profit-sharing plan. See section 3.02 of Revenue Procedure 2000-6, I.R.B. 2000-1 187, issued on January 02, 2000.

IV. Financial Accounting and Reporting

As stated above, SFAS 106 originally provided financial accounting and reporting requirements for postretirement benefit obligations other than pensions. Additional financial and reporting requirements also apply to these postretirement benefits and for pension plans that provide these benefits.

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IV(a). AICPA Statement of Position (SOP) 99-2

AICPA Statement of Position (SOP) 99-2, Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans, requires disclosures relating to section 401(h) retiree medical accounts. This Statement requires disclosures in financial accounting statements included in Form 5500, Annual Return/Report of Employee Benefit Plan, filings for plan years beginning after December 15, 1998, with earlier application encouraged. Accounting changes required on adoption of the SOP should be made retroactively by restatement of financial statements for prior periods.

This Statement provides for separate financial accounting and reporting disclosures for defined benefit pension plans and health and welfare benefit plans containing section 401(h) features.

Defined benefit pension plan financial statements must disclose that section 401(h) accounts assets are only available to pay retiree health benefits. Health and welfare benefit plan financial statements must disclose that retiree health benefits are partially funded through a section 401(h) account of the defined benefit pension plan. For additional information access www.aicpa.org.

IV(b). Statement of Financial Accounting Standard (SFAS) 132

Statement of Financial Accounting Standards 132 (SFAS), Employers' Disclosures about Pensions and Other Post Retirement Benefits, standardizes the disclosure requirements under SFAS 106 and SFAS 87 effective for fiscal years beginning after December 15, 1997.

This statement suggests a parallel format for presentation of information about pensions and other postretirement benefits in company financial statements. For additional information access www.fasb.org.

V. How Do You Identify a Section 401(h) Retiree Medical Account

When reviewing a determination letter application or conducting an examination, the agent should review the defined benefit plan (or money purchase plan) document for any plan language describing medical benefits to determine whether the provisions of section 401(h) have been met. Most plans providing these benefits contain a separate section that

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is easily recognizable by the incorporation of standard language from section 401(h) of the Code.

In addition, beginning with 1999 plan years, the agent should inspect Form 5500 for a code for pension benefit features in Box 6a to determine whether the pension plan contains a section 401(h) account. Pension plans featuring a section 401(h) account should indicate code 1E in Box 6a.

For plan years beginning before 1999, the agent may issue an information document request with the following items:

- Is the taxpayer funding retiree health benefits through a section 401(h) account within a qualified pension plan?
- If so, what was the date of adoption of the section 401(h) account and what was the effective date of the account?

If a section 401(h) account is maintained, the agent may use the information document request in Appendix C in order to request the basic information for examining this issue.

Another method for identifying a section 401(h) account when conducting an examination is to review the employer's ledger accounts for health benefits. Usually, separate ledger accounts exist for active employee and retiree health benefits. Separate labels within the retiree health ledger account may be an indication that the employer is funding retiree health benefits utilizing a section 401(h) account and/or VEBA trust.

VI. What Should You Review on a Determination Letter Application

The following items should be considered by the agent reviewing a determination letter application. The agent should determine whether a prior determination letter considered plan provisions relating to section 401(h) and determine whether the current plan provisions meet the requirements of this section. Most plans providing benefits in a section 401(h) account incorporate language verbatim from section 401(h) of the Code. If the language of the statute is modified, the agent may wish to consult a TE/GE actuary or request technical advice.

If a prior determination letter approved plan provisions that did not meet the requirement of section 401(h), the agent should consider sections

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5.01, 5.02 and 21.05 of Revenue Procedure 2000-6 that provide the parameters of reliance by employers on determination letters.

In addition, Internal Revenue Manual sections 7717.2(1) and 7717.1(5) generally provide that a ruling or determination letter found to be in error or not in accord with the current views of the Service may be modified or revoked. Modification or revocation may be effected by a notice to the taxpayer to whom the ruling or determination letter originally was issued, or by a revenue ruling or other statement published in the Internal Revenue Bulletin.

Accordingly, the agent should notify the employer or employer's representative in writing that the plan should be amended to reflect the correct language.

VI(a). Section 401(h) is a Qualification Provision

Section 401(a) of the Code provides the requirements for qualification for deferred compensation plans. Section 401(a)(1) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if the contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan.

Section 1.401-1(b)(1)(i) of the Income Tax Regulations provides that a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of section 1.401-14).

Section 401(h) of the Code permits a pension plan to provide for the payment of benefits for medical expenses of retired employees, their spouses, and their dependents, but only if certain provisions are met. These provisions include sections 401(h)(1) through (h)(6) discussed later in this text.

The Committee Reports for Public Law 87-863 state that under present law (prior to the enactment of section 401(h)), however, it is impossible for an employer to fund such (medical) benefits through a qualified plan.

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* * * The present language of section 401 of the Internal Revenue Code, however, has been interpreted as making a pension plan which provides other than pension benefits nonqualified, and thus the employer would lose his deduction for amounts contributed. * * *

A pension plan which provides the benefits described in the new subsection (section 401(h)) and which otherwise satisfies the requirements set forth in section 401(a) of the Code will not be considered as a qualified plan unless it also satisfies the requirements of paragraphs (1), (2), (3), (4) and (5) of the new subsection. See, H. Rep. No. 2317, 87th Congress, 2nd Sess. at 1205, 1206, 1207 (1962).

Thus, if a pension plan containing a section 401(h) retiree medical benefits account fails to meet the provisions of section 401(h) in form or operation, the pension plan and trust fail to qualify under sections 401(a) or 501(a) of the Code.

VI(b). Revenue Procedure 2000-6

When reviewing a determination letter application, the agent should review the cover letter to determine whether the employer or employer's representative has requested a ruling on the section 401(h) account language in accordance with Revenue Procedure 2000-6. Appendix A of this text contains a checklist agents should utilize when reviewing determination letter applications. Appendix A also contains the provisions relating to when rulings will or will not be issued on section 401(h) accounts within a pension plan. Note that Form 6406 may not be used to request a determination letter that considers section 401(h).

VI(c). Subordination Limitation

Section 401(h)(1) of the Code provides that medical benefits provided by the plan must be subordinate to the retirement benefits provided by the plan.

The Omnibus Reconciliation Act of 1989 (OBRA '89) modified section 401(h) of the Code by adding the following language, "In no event shall the requirements of paragraph (1) [the subordination requirement] be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25 percent of the total actual contributions to the plan (other

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than contributions to fund past service credits) after the date on which the account is established."

Section 1.401-14(c) of the regulations provides the requirements that must be met for a qualified pension or annuity plan to provide medical benefits described in section 401(h).

Section 1.401-14(c)(1)(i) of the regulations states, in part, that the medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits.

Although section 401(h) of the Code was modified by OBRA'89, the regulations pertaining to section 401(h) of the Code have not been revised.

Thus, the language regarding the subordination test in section 1.401-14(c)(1)(i) of the regulations has been supplemented by the statutory language in section 401(h) added by OBRA '89.

When reviewing a determination letter application, the agent should ensure that the plan provisions include the subordination limitation language added by OBRA' 89 in accordance with section 401(h)(1) of the Code.

To better understand the mechanics of the subordination limitation, the following illustrations are provided.

SIMPLIFIED ILLUSTRATION OF THE SUBORDINATION LIMITATION:

Section 401(h) Retiree Medical Contribution	\$ 6 million
Pension Contribution	\$ 18 million

Total Contribution to Pension Plan Trust
(other than contributions to fund past service credits) \$ 24 million

In this example, the limitation under the Code is met since the retire health contribution does not exceed the 25% threshold. That is, the \$6 million contribution to the section 401(h) account does not exceed 25% the total \$24 million contribution to the trust.

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This calculation is often determined by actuaries on a “1/3” basis in their actuarial reports. For example, the \$6 million contribution to the section 401(h) account does not exceed 1/3 of the \$18 million contribution to the pension portion of the trust.

Thus, the limitation for contributions to the section 401(h) medical account could not exceed 1/3 of the pension contribution or in a similar manner, 25% of the total contributions to the trust (the pension contributions plus the section 401(h) contributions). Either form of calculation nets the same result mathematically. Note that this example does not consider past service credits or life insurance protection.

Under section 401(h) of the Code, the subordination limitation is premised on calculating the amount of actual employer pension contributions to the plan and aggregate actual contributions for medical benefits from the date the section 401(h) account is established.

The subordination provision is an “aggregate” or cumulative test. Thus, in each year the subordination limitation is calculated during an examination, all contributions to the plan since the date of establishment of the section 401(h) account must be considered.

DETAILED ILLUSTRATION OF THE AGGREGATE SUBORDINATION LIMITATION

	1999	2000	Cumulative Total
Pension Contributions (Other than to fund past service credits)	\$ 20.4 Million	\$ 16.0 Million	\$ 36.4 Million
401(h) Account Contributions	\$ 2.0 Million	\$ 6.0 Million	\$ 8.0 Million
Total Contribution	\$ 22.4 Million	\$ 22.0 Million	\$ 44.4 Million
401(h) as % of Total	8.9 %	27.3 %	18.0 %
Subordination Limit Test	PASSES for 1999		PASSES for 2000

In the example above, it is assumed that the 401(h) account is established in 1999 and the relevant contributions are as shown in the table. Since \$ 2.0 million is less than 25% of \$ 22.4 million, the plan meets the subordination test for 1999. However, since the test is a cumulative test, even though \$ 6.0 million is more than 25% of \$ 22.0 million, the plan meets the subordination test for 2000 on a cumulative basis.

VI(C)(1). DATE OF ESTABLISHMENT

The following discusses how the agent should determine the "date of establishment" during an examination or when reviewing a determination letter application.

The Committee report for OBRA'89 states "Internal Revenue Service General Counsel Memorandum 39785 (GCM 39785), issued on April 3, 1989 is rejected to the extent it concludes that contributions to a section 401(h) account may be based on plan costs rather than actual contributions to the plan. The committee intends that the present-law rules relating to section 401(h) accounts not be expanded or modified by the Secretary in a manner that would allow increased contributions to the section 401(h) account above what is permitted under present law and this provision."

Accordingly, if the "date of establishment" of a section 401(h) account is the effective date of the plan amendment adding the 401(h) account, then the "date of establishment" could be retroactive to a date prior to the date of adoption of an amendment (such as the first day of the plan year). This would have the effect of allowing the taxpayer to include contributions made to the pension plan between the effective date of the account and the date of adoption of the amendment establishing the account in satisfying the subordination test.

In changing the law, Congress specifically intended to overturn that portion of GCM 39785 which had concluded that the subordination test could be based on "cost" rather than actual contributions. GCM 39785 had allowed a 401(h) account to use pension cost for the entire plan year in which the amendment to add the 401(h) account was effective. In amending the law Congress specifically stated that the subordination test is to be based upon the actual contributions made after the "date of establishment" of the section 401(h) account.

Thus, the "date of establishment," for purposes of section 401(h), is the later of the adoption date of the plan amendment adding the 401(h) account or the effective date of such plan amendment.

Many practitioners and taxpayers misinterpret this Code section and calculate the contribution limitation under section 401(h) based upon a retroactive effective date instead of the actual date of adoption. Retroactive application results in the taxpayer claiming a greater deduction than entitled to because it is improperly determined based upon pension contributions made prior to the date of adoption. In addition,

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utilizing a retroactive effective date may cause the subordination test to be exceeded in violation of section 401(h)(1).

The following shows the effect on the previous illustration if part of the \$20.4 million pension contribution in 1999 were made prior to the date of adoption (i.e. "establishment").

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improper date of establishment, the agent should consider the introductory discussion of section VI of this text.

While the agent reviewing a determination letter application would not have access to the contribution information and would not be able to verify failure in operation, the examples are included to demonstrate the implications and importance of proper plan language.

VI(d). Separate Accounts

Section 401(h)(2) provides that a separate account must be established and maintained.

Section 1.401-14(c)(2) of the regulations provides that section 401(h) requires that a separate account must be established and maintained within the pension trust to provide for retiree medical benefits under this section. This provision requires a separate accounting of the medical benefits provided within the pension plan.

VI(e). Reasonable and Ascertainable Benefits

Section 401(h)(3) provides that the employer's contribution to such account must be reasonable and ascertainable.

Section 1.401-14(c)(1)(i) of the regulations provides that a qualified plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid.

Section 1.401-14(c)(3) of the regulations provides that section 401(h) requires that amounts contributed to fund medical benefits therein described must be reasonable and ascertainable.

Where the plan language provides indications of other sources of payment for retiree medical benefits, e.g., a VEBA or the general funds of the employer, the agent should review the plan to determine whether the plan provisions specify the amounts of benefits, the priority of payment and the time period with respect to which benefits will be paid from each source.

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 plan must be specific as to how the benefits payable from the section 401(h) account are coordinated with benefits payable from other sources.

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Without such specificity, a plan participant will not be able to know the amount of medical benefits which will be paid, and the contributions with respect to medical benefits payable from the section 401(h) account are not ascertainable. The plan may not allow for employer discretion in the timing and amount of benefit payments.

Thus, in accordance with the Code and regulations of this section of the text, the plan must contain provisions for determining the amount that will be paid. These requirements will not be satisfied unless the terms of the plan specify the amount of benefits, the priority of payment from each source and the time period with respect to which benefits will be paid.

VI(f). No Diversion or Reversion

Section 401(h)(4) provides that all contributions (within the taxable year or thereafter) to the 401(h) account must be used to pay benefits provided under the medical plan and must not be diverted to any purpose other than the providing of such benefits.

Section 401(h)(5) of the Code provides that notwithstanding the provisions of subsection (a)(2), upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the plan, be returned to the employer.

Section 1.401-14(c)(4) of the regulations provides that it must be impossible at any time prior to satisfaction of all liabilities under the plan for any part of the corpus or income to be used for or diverted to any purposes other than providing medical benefits under the account. Consequently, a plan which, for example, under its terms, permits funds in the medical account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a).

VI(g). Key Employee Accounts

Section 401(h)(6) of the Code provides that in the case of an employee who is a key employee, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are only payable to such employee (and his spouse and dependents) from such separate account. The term "key employee" means any employee, who at any time during the plan year or any

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preceding plan year during which contributions were made on behalf of such employee, is or was a key employee as defined in section 416(i).

Thus, the agent should review plan provisions to ensure the plan language reflects section 401(h)(6) where medical benefits are to be provided to key employees. Where key employees are excluded from eligibility for medical benefits under the section 401(h) account, the agent should ensure that the plan provisions specifically provide for this exclusion.

VI(h). Employee or Employer Contributions

Treasury Regulation 1.401-14(b)(3) states that contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or non-contributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions.

Where the plan is ambiguous as to whether contributions to the section 401(h) account are provided entirely from employer contributions or whether they will be paid from employer and employee contributions, the agent should request a clarifying amendment to the plan.

VI(i). Caveats

For determination applications that include a cover letter requesting consideration of section 401(h) features, these provisions should be reviewed. A caveat stating that section 401(h) was reviewed in accordance with the cover letter for the application should be included on the determination letter in accordance with section 2.04 of Revenue Procedure 2000-6.

For plans which contain section 401(h) provisions where a ruling was not requested, the agent should include a caveat stating that the section 401(h) features were not reviewed since the applicant did not request such review in accordance with section 2.04 of Revenue Procedure 2000-6.

A caveat such as the following is inappropriate for section 401(h) features in a pension or annuity plan. This caveat applies only to defined

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contribution plans that provide for medical or disability benefits as described in section 1.401-1(b)(1)(ii) of the Income Tax Regulations.

This letter does not express an opinion with respect to whether (disability benefits or medical care benefits) are acceptable as accident or health plan benefits, nor does it express an opinion on the taxability of such benefits under sections 105 or 106.

VI(j). Section 420 Transfers

Section 420 of the Code permits the transfer of assets in a defined benefit plan from the defined benefit portion of the plan to a section 401(h) account within the same pension trust for payment of current retiree medical benefits.

When reviewing a determination letter application, the agent should review the cover letter to determine whether the employer or employer's representative has requested a ruling on the section 420 plan provisions in accordance with Revenue Procedure 2000-6. Appendix B of this text contains a checklist agents should utilize when reviewing these determination letter applications. Appendix B also contains the provisions relating to when rulings will or will not be issued on section 420. Note that Form 6406 may not be used to request a determination letter that considers section 420.

VII. Deductions for Welfare Benefits Exclusive of Section 401(h)

This section discusses the general concepts applicable to the deduction of employer contributions when a trust is not utilized or when the employer establishes a VEBA trust to fund these benefits. Deductions for employer contributions to a section 401(h) account are discussed in section VIII of this text.

VII(a). Deduction Without the Use of a Trust

To understand why an employer would consider using a trust to provide employee benefits, it is helpful to first review the basic mechanics of a deduction in situations where no funding vehicle is used. An employer's deduction for the expense of providing welfare benefits to its employees is governed by sections 162 and 461 of the Code at the time the employer pays (or properly accrues) the expense liability. The lead case in this area is *General Dynamics Corporation v. United States*, 107 S. Ct. 1732; 481 U.S. 239 (1987). These costs may be paid to the employee, the care provider, or an insurance company. They may also be paid through a third party benefit administrator.

In the absence of a trust, employers generally may only deduct amounts paid for these benefits on a pay-as-you-go basis. In order to prefund and

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deduct amounts for future benefit obligations, employer contributions must be funded through a trust.

VII(b). Funding Welfare Benefit Obligations

Employers may decide to fund their obligations to provide employee welfare benefits through the use of a trust. An irrevocable employee welfare benefit trust created by an employer can place assets beyond the reach of the creditors of the employer and can provide employees with some assurance that assets will be available to pay the promised benefits.

In addition, funding benefits obligations through a trust may provide employers the opportunity to fund and deduct a greater amount of contributions to employee welfare benefit plans as permitted by the Code.

Title I of ERISA, Act section 3, defines an "employee welfare benefit plan" and "welfare plan" as any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise,

- (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or
- (B) any benefit described in section 302(c) of the Labor Management Relations Act of 1947, 29 USCS section 186(c), (other than pensions on retirement or death, and insurance to provide such pensions).

Thus, an "employee welfare benefit plan" is a program of benefits provided to employees. The plan is usually embodied in a written plan document. Generally, Title I of ERISA requires the employer to prepare a "summary plan description" explaining the essential features of the plan and to furnish a copy of this summary plan description to each employee.

The "trust" is the employer's vehicle for funding its obligation under a plan or plans. A trust is usually established by a written trust instrument naming the employer as the settlor of the trust, appointing a trustee, and describing the powers and duties of the trustee.

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An employer may choose to fund some, or all, of the benefits under its plan through one or more trusts. A trust may cover more than one plan, e.g., a medical plan and a disability plan. The trust instrument will set forth the benefits that the trustee will pay out of the trust fund. The employer will be responsible for paying other plan benefits, either directly from the employer's general accounts or through a different trust.

Within the context of this text, welfare benefits may be funded through either a VEBA trust or through a section 401(h) account contained within a section 401(a) pension plan trust (unless paid without the use of a trust).

For a pension trust that contains a section 401(h) account, the trustee files a Form 5500 information return for the pension trust. In the event the pension trust is no longer "qualified" under section 401(a) of the Code, the trustee files Form 1041, U.S. Fiduciary Income Tax Return for the taxable trust.

VII(c). Deduction Using a VEBA Trust

For a VEBA trust, the trustee files Form 990, Return of Organization Exempt from Income Tax, for exempt trusts. In the event the trust is no longer "exempt" from taxes under sections 501(c)(9) and 501(a) of the Code, the trustee files Form 1041, U.S. Fiduciary Income Tax Return for the taxable trust.

Deductions for employer contributions to VEBA trusts are governed by sections 419 and 419A of the Code. In the event contributions to the VEBA are "overfunded" as determined under these Code sections, the trust may be required to file Form 990-T, Exempt Organization Business Income Tax Return. See Employee Plans CPE Technical Topics for 1998 Training 4213-018 (Rev.5/98) for additional information on VEBA deduction issues. The text may be accessed at <http://ftp.fedworld.gov/pub/irs-utl/lesson5.pdf>.

VIII What Should You Review During an Examination

The following sections discuss specific issues to be considered by the agent when examining a pension plan containing a section 401(h) account. These sections should be considered in conjunction with the provisions discussed in section VI of this text in order to determine whether these provisions qualify under section 401(h) of the Code in operation.

VIII(a). Section 162 Deduction Provisions Applicable to Section 404

Deductions for employer contributions to a section 401(h) account are generally governed by section 404 of the Code which is derived from the general business deductions permitted under section 162.

Section 162(a) of the Code generally provides a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(o) of the Code provides a cross-reference to section 404 for deductibility for deferred compensation and other deferred benefits.

Section 1.162-10(a) of the regulations provides that accident or health benefits which may be deductible under this section are governed by and deductible under section 404 of the Code if the benefits are provided as part of a pension or other deferred compensation plan referred to in section 404(a).

Section 1.404(a)-1(b) of the regulations provides that in order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a).

VIII(b). Section 404 Deduction Provisions for Section 401(h)

When examining the deduction of employer contributions to a section 401(h) account within a pension plan, the agent should consult with a TE/GE actuary in determining the limitation thereunder. The remainder of this section of the text describes the Code and regulations that apply in determining the deductible limits for contributions to a section 401(h) account.

Section 404(a)(1) of the Code limits deductible contributions to one or more defined benefit pension plans or money purchase pension plans maintained by an employer which are funded through a trust.

Section 404(a)(2) of the Code limits deductible contributions to one or more defined benefit pension plans or money purchase pension plans

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maintained by an employer which are funded through annuity contracts or annuity contracts and medical benefits as described in section 401(h).

Section 1.404(a)-3(a) of the regulations provides if contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see section 1.404(a)-1), the contributions are deductible under section 404(a)(1) or (2) if the further conditions provided therein are also satisfied.

Section 1.404(a)-3(a) of the regulations continues by stating that where medical benefits described in section 401(h) and as defined in paragraph (a) of section 1.401-14 are provided for retired employees, their spouses, or their dependents under the plan, deductions on account of such subordinate benefits are also covered under section 404(a)(1) or (2).

Section 1.404(a)-3(f)(1) of the regulations provides that in determining the amount which is deductible with respect to contributions to provide retirement benefits under a plan, amounts contributed for the funding of medical benefits described in section 401(h) of the Code shall not be taken into consideration.

Section 1.404(a)-3(f)(2) of the regulations further provides that the amounts deductible with respect to employer contributions to fund medical benefits described in section 401(h) shall not exceed the total cost of providing such benefits. The total cost of providing such benefits shall be determined in accordance with any generally accepted actuarial method which is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The amount deductible for any taxable year with respect to such cost shall not exceed the greater of

- (i) an amount determined by distributing the remaining unfunded costs of past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or
- (ii) 10 percent of the cost which would be required to completely fund or purchase such medical benefits.

In determining the amount deductible, section 1.404(a)-3(f)(2) of the regulations provides that an employer must apply either

- (i) above for all employees or
- (ii) above for all employees.

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Thus, the provisions above apply to limit the deduction of employer contributions for medical benefits provided through a section 401(h) account.

The Committee Reports state that the second requirement under section 401(h) is that a separate account must be established. This allocation is necessary in order to enable the Commissioner of Internal Revenue to determine whether the actuarial limitations imposed by section 404 of the Code on deductions claimed for pension contributions are properly applied. See, H. Rep. No. 2317, 87th Congress, 2nd Sess. at 1208.

The Committee Reports state that the third requirement is that the employer's contribution to fund medical and other benefits must be reasonable and ascertainable. Thus, it must be possible under the plan to determine the portion of the employer's contribution which is made to fund the pension benefits and the portion of the contribution made under the plan which is made to fund the medical, etc. benefits. As under existing law, if any portion of the contribution to provide either pension or medical, etc. benefits does not meet the ordinary and necessary tests, the employer will not be permitted to deduct the entire amount of such contribution under section 404 of the Code. See, H. Rep. No. 2317, 87th Congress, 2nd Sess. at 1208.

Treasury Regulation 1.404(a)-3(a) detailed above and these Committee Reports imply a connection between meeting the subordination test of section 401(h)(1) in operation and deductibility of those contributions under section 404.

VIII(c). Section 404(a)(7) Applicability

Section 404(a)(7) of the Code applies to limit the amount otherwise deductible under paragraphs (1), (2) or (3) of section 404(a) for employer contributions to one or more defined contribution plans and one or more defined benefit plans. In general, the total amount deductible in a taxable year under such plans shall not exceed the greater of (i) 25 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under such plans, or (ii) the amount of contributions made to or under the defined benefit plans to the extent such contributions do not exceed the amount of employer contributions necessary to satisfy the minimum funding standard provided by section 412 with respect to any such defined benefit plans.

Under section 401(h) of the Code, a pension plan may provide for the payment of medical benefits for retired employees, their spouses and

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dependents, if, among other provisions, a separate account is established and maintained for such benefits.

Section 1.404(a)-3(f)(1) of the regulations provides that in determining the amount which is deductible with respect to contributions to provide retirement benefits under a plan, amounts contributed for the funding of medical benefits described in section 401(h) of the Code shall not be taken into consideration.

For deduction purposes, therefore, a pension plan that includes a section 401(h) retiree medical benefits account is treated under the provisions of the Code and regulations as two separate plans, one providing medical benefits and the other providing retirement benefits.

While section 404(a)(7) of the Code applies to limit the deductions otherwise allowed under section 404 for contributions made to fund retirement benefits, if the contributions are made to provide medical benefits described in section 401(h) of the Code and are kept in one or more separate accounts, such contributions will not be subject to the aggregate deductible limitation under section 404(a)(7) of the Code. The deductibility of these contributions will be determined in accordance with the rules and limitations in section 1.404(a)-3(f) of the regulations.

VIII(d). Section 263A Uniform Capitalization

The application of section 263A of the Code to deductions governed by section 404 are currently being considered by the Section 263A Technical Advisor and the Cafeteria Plan Technical Advisors.

Section 404 of the Code contains the general limitations on the deductibility of contributions made to qualified retirement plans. Section 404 similarly applies to contributions made to section 401(h) retiree medical accounts. Generally, if contributions made for qualified retirement plans and section 401(h) accounts meet the provisions of section 404 and the regulations thereunder, they are deductible in their entirety in accordance with this section.

However, the provisions of section 263A of the Code require that certain expenses must be capitalized instead of currently expensed and deducted. Section 263A generally requires the capitalization of otherwise deductible direct and indirect costs properly allocable to real property and tangible personal property produced by a taxpayer as well as property acquired by a taxpayer for resale.

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THE SECTION 263A COSTS ARE COMPUTED AS FOLLOWS:

Section 471 costs
+ Additional 263A costs
+ Interest capitalized under 263A
Section 263 Costs
=====

Direct and indirect costs are defined in Treas. Reg. 1.263A-1(e). Indirect costs are defined as all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. **Indirect costs as defined in the regulations include employer contributions for qualified retirement plans, health insurance, life insurance and other employee welfare and fringe benefits. See Treas. Reg. 1.263A-1(e)(3)(D).**

Any questions relating to the applicability of section 263A to contributions governed by section 404 may be directed to James Peschl, Section 263A Technical Advisor, at (763) 549-1020, extension 330 or the Cafeteria Plan Technical Advisors at the telephone numbers listed in [Appendix D](#).

IX. Other Examination Issues

When examining the subordination limitation of section 401(h), the agent should also consider section VI(c) of this text in order to determine whether the qualification provisions of section 401(h) have been met in operation.

IX(a). Subordination Limitation

The Omnibus Reconciliation Act of 1989 (OBRA'89) modified section 401(h) of the Code by adding the following language, "In no event shall the requirements of paragraph (1) [(the subordination requirement)] be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established."

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If a prior determination letter was issued which approved a retroactive effect date, or other plan provision defects under section 401(h), the agent should consider the following.

Sections 5.01, 5.02 and 21.05 of Revenue Procedure 2000-6 provide the parameters of reliance by employers on determination letters. Section 21.05 states that while a favorable determination letter may serve as a basis for determining deductions for employer contributions thereunder, it is not to be taken as an indication that contributions are necessarily deductible as made. This latter determination can be made only upon an examination of the employer's tax return, in accordance with the limitations, and subject to the conditions of section 404 of the Code.

The determination letter specifically states that it relates to the qualified status of the plan and refers in a caveat to a section of Publication 794 entitled "Limitations of a Favorable Determination Letter." Publication 794 is attached to all determination letters. This section provides that, "a determination letter does not consider whether actuarial assumptions are reasonable for funding or whether a specific contribution is deductible (emphasis added).

Internal Revenue Manual sections 7717.2(1) and 7717.1(5) generally provide that a ruling or determination letter found to be in error or not in accord with the current views of the Service may be modified or revoked. Modification or revocation may be effected by a notice to the taxpayer to whom the ruling or determination letter originally was issued, or by a Revenue Ruling or other statement published in the Internal Revenue Bulletin.

Accordingly, the Service should notify the taxpayer that the plan should be amended prospectively to use a corrected "date of establishment" when calculating the aggregate subordination limitation under section 401(h) and the corresponding deduction under section 404 of the Code for current and subsequent plan years.

During an examination, Form 5701, Notice of Proposed Adjustment, should be used to formally notify the taxpayer of prospective application.

IX(A)(1). LIFE INSURANCE PROTECTION

The Omnibus Reconciliation Act of 1989 (OBRA'89) modified section 401(h) of the Code by adding the following language, "In no event shall the requirements of paragraph (1) [(the subordination requirement)] be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the

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plan, exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established."

Treas. Reg. 1.401-14(c)(1) provides that life insurance protection includes any benefit paid under the plan on behalf of an employee-participant as a result of the employee-participant's death to the extent such payment exceeds the amount of the reserve to provide retirement benefits existing at his death (note that this regulation has not been revised to reflect OBRA '89 statutory change which codified the subordination test).

Thus, the section 401(h) subordination limitation is further reduced by any contributions to the qualified plan for life insurance protection. The term "life insurance protection" is not further clarified by the Code or regulations. Therefore, the agent should consult with their TE/GE field actuary for assistance in determining this component of the subordination limitation or consider requesting technical advice.

IX(A)(2). PAST SERVICE CREDITS

The Omnibus Reconciliation Act of 1989 (OBRA'89) modified section 401(h) of the Code by adding the following language, "In no event shall the requirements of paragraph (1) [(the subordination requirement)] be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established."

Thus, the section 401(h) subordination limitation must be based upon retirement plan contributions other than contributions to fund past service credits. Often when determining the subordination limitation, taxpayers improperly use the total amount of pension contributions instead reducing the amount of pension contributions by the portion of the contribution to fund "past service credits."

Note that "contributions to fund past service credits" probably is the same thing as past service contributions. However, the term "past service credits" referenced in section 401(h) is not further clarified by the Code or regulations. Therefore, the agent should consult with their TE/GE field actuary for assistance in determining the amount the "contributions to fund past service credits" or consider requesting technical advice.

IX(b). Key Employee Accounts

Section 401(h)(6) of the Code provides that in the case of an employee who is a key employee, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits are only payable to such employee (and his spouse and dependents) from such separate account. The term "key employee" means any employee, who at any time during the plan year or any preceding plan year during which contributions were made on behalf of such employee, is or was a key employee as defined in section 416(i).

Therefore, the plan should state whether "key employees" are eligible to participate. The plan may not provide that the employer has the discretion to determine at any time whether key employees may participate or whether only certain key employees may participate.

During an examination, the agent should review plan records to verify that separate accounts are established or maintained for **each of the** key employees and that benefits are only payable to key employees from their separate account as provided in section 401(h) of the Code.

IX(c). Section 415 Considerations

Section 415 of the Code provides the limitations on benefits and contributions under qualified plans. Section 415(c) of the Code provides the limitations on benefits and contributions for defined contribution plans.

Section 415(l) of the Code provides for the treatment of certain medical benefits under section 415 of the Code. This section provides:

- (1) In general. For purposes of this section, contributions allocated to any individual medical account which is part of a pension or annuity plan shall be treated as an annual addition to a defined contribution plan for purposes of subsection (c). Subparagraph (B) of subsection (c)(1) shall not apply to any amount treated as an annual addition under the preceding sentence.
- (2) Individual medical benefit account. For purposes of paragraph (1), the term "individual medical benefit account" means any separate account—
 - (A) which is established for a participant under a pension or annuity plan, and

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- (B) from which benefits described in section 401(h) are payable solely to such participant, his spouse, or his dependents.

Thus, when examining a section 401(h) account and/or a qualified defined contribution plan, the agent should consider amounts contributed to key employee accounts in a section 401(h) account when determining whether the limitations of section 415(c) for the defined contribution plan have been met.

Similar provisions apply to key employee accounts in a VEBA trust. Section 419A(d) provides the requirement of separate accounts for post-retirement medical or life insurance benefits provided to key employees in a VEBA trust. This section provides:

- 1 In general. In the case of any employee who is a key employee--
 - (A) a separate account shall be established for any medical benefits or life insurance benefits provided with respect to such employee after retirement, and
 - (B) medical benefits and life insurance benefits provided with respect to such employee after retirement may only be paid from such separate account. The requirements of this paragraph shall apply to the first taxable year for which a reserve is taken into account under subsection (c)(2) and to all subsequent taxable years.
- (2) Coordination with section 415. For purposes of section 415, any amount attributable to medical benefits allocated to an account established under paragraph (1) shall be treated as an annual addition to a defined contribution plan for purposes of section 415(c). Subparagraph (B) of section 415(c)(1) shall not apply to any amount treated as an annual addition under the preceding sentence.
- (3) Key employee. For purposes of this section, the term 'key employee' means any employee who, at any time during the plan year or any preceding plan year, is or was a key employee as defined in section 416(i).

Thus, when examining a VEBA, section 401(h) account and/or a qualified defined contribution plan, the agent should consider amounts contributed to key employee accounts in a VEBA and a section 401(h) account when determining whether the limitations of section 415(c) for the defined contribution plan have been met.

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While separate accounts are not required for employees who are not key employees, there is nothing that precludes a plan from establishing separate accounts under section 401(h) or in a VEBA for each employee. If that is the case, the agent should consider amounts contributed to each account when determining whether the limitations of section 415(c) for the defined contribution plan have been met. Note that in the typical case separate accounts are not established for employees who are not key employees.

IX(d). Section 420 Considerations

If the agent encounters any activity involving transfer of assets as described in section 420 of the Code, the agent should review the requirements of section VI(i) and Appendix B of this text and should consult with their TE/GE field actuary for assistance.

Appendix A: Rev. Proc. 2000-6 Section 401(h) Ruling Sections and Checklist

Revenue Procedure 2000-6 sets forth the procedures of the various offices of the Internal Revenue Service for issuing determination letters on the qualified status of pension, profit-sharing, stock bonus, annuity, and employee stock ownership plans (ESOPs) under sections 401, 403(a), 409 and 4975(e)(7) of the Internal Revenue Code of 1986, and the status for exemption of any related trusts or custodial accounts under section 501(a).

This revenue procedure also contains the provisions to consider when reviewing a determination letter application where the plan includes section 401(h) features.

Section 2.04, of Revenue Procedure 2000-6, references changes made for section 401(h) provisions. This section provides that Section 16 has been modified to state that a determination letter that considers whether the requirements of 401(h) are satisfied in a plan will be issued only if the plan sponsor requests such consideration in a cover letter submitted with the application and indicates in the cover letter the location of plan provisions that satisfy the requirements of section 401(h).

Section 3.02, of Revenue Procedure 2000-6, discusses areas in which determination letters will not be issued. Section (4) applies to determination letter requests with respect to plans that combine an ESOP (as defined in section 4975(e)(7) of the Code) with retiree medical benefit features described in section 401(h) (HSOPs). Otherwise, determinations will consider section 401(h) in accordance with sections 2.04 and section 16. This section provides the following:

- (a) In general, determination letters will not be issued with respect to plans that combine an ESOP with an HSOP with respect to:
 - (i) whether the requirements of section 4975(e)(7) are satisfied;
 - (ii) whether the requirements of section 401(h) are satisfied; or
 - (iii) whether the combination of an ESOP with an HSOP in a plan adversely affects its qualification under section 401(a).
- (b) A plan is considered to combine an ESOP with an HSOP if it

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contains ESOP provisions and section 401(h) provisions.

- (c) However, an arrangement will not be considered covered by section 3.02(4) of this revenue procedure if, under the provisions of the plan, the following conditions are satisfied:
- (i) No individual accounts are maintained in the section 401(h) account (except as required by section 401(h)(6));
 - (ii) No employer securities are held in the section 401(h) account;
 - (iii) The 401(h) account does not contain the proceeds (directly or otherwise) of an exempt loan as defined in section 54.4975-7(b)(1)(iii) of the Pension Excise Tax Regulations; and
 - (iv) The amount of actual contributions to provide section 401(h) benefits (when added to actual contributions for life insurance protection under the plan) does not exceed 25 percent of the sum of: (1) the amount of cash contributions actually allocated to participants' accounts in the plan and (2) the amount of cash contributions used to repay principal with respect to the exempt loan, both determined on an aggregate basis since the inception of the section 401(h) arrangement.

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Section 16, of Revenue Procedure 2000-6, references the requirements for section 401(h) and section 420 determination letters. Section 16.01 states that this section provides procedures for requesting determination letters (i) with respect to whether the requirements of section 401(h) are satisfied in a plan with retiree medical benefit features and (ii) on plan language that permits, pursuant to section 420, the transfer of assets in a defined benefit plan to a health benefit account described in section 401(h).

Section 16.02, of Revenue Procedure, 2000-6, provides the information required for section 401(h) determinations. This section states that EP determinations will issue a determination letter that considers whether the requirements of section 401(h) are satisfied in a plan with retiree medical benefit features only if the plan sponsor's application includes, in addition to the application forms and any other material required by this revenue procedure, a cover letter that requests consideration of section 401(h). The cover letter must specifically state that consideration is being

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requested with regard to section 401(h) in addition to other matters under section 401(a) and must specifically state the location of plan provisions that satisfy the requirements of section 401(h).

Part I of the checklist in the Appendix of this revenue procedure may be used to identify the location of relevant plan provisions. Form 6406 may not be used to request a determination letter that considers section 401(h).

APPENDIX/CHECKLIST

As part of a section 401(h) or section 420 determination letter request described in section 16 of this revenue procedure the following checklist may be completed and attached to the determination letter request. If the request relates to section 401(h) but not to section 420, complete Part I only. If the request relates to section 420, complete Parts I and II (Part II is contained in Appendix B of this text).

CIRCLE SECTION

PART I

1. Does the Plan contain a medical benefits account within the meaning of section 401(h) of the Code? Yes No _____ If
the medical benefits account is a new provision, items "a" through "h" should be completed.
- a. Does the medical benefits account specify the medical benefits that will be available and contain provisions for determining the amount which will be paid? Yes No _____
- b. Does the medical benefits account specify who will benefit? Yes No _____
- c. Does the medical benefits account indicate that such benefits, when added to any life insurance protection in the Plan, will be subordinate to retirement benefits? (This requirement will not be satisfied unless the amount of actual contributions to provide section 401(h) benefits Yes No _____

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(when added to actual contributions for life insurance protection under the Plan) does not exceed 25 percent of the total actual contributions to the Plan (other than contributions to fund past service credits), determined on an aggregate basis since the inception of the section 401(h) arrangement.)

- d. Does the medical benefits account maintain separate accounts with respect to contributions to key employees (as defined in section 416(i)(1) of the Code) to fund such benefits? Yes No _____
- e. Does the medical benefits account **state that** amounts contributed must be reasonable and ascertainable? **Merely stating in not enough. See above.** Yes No _____
- f. Does the medical benefits account provide for the impossibility of diversion prior to satisfaction of liabilities (other than item "7" below)? Yes No _____
- g. Does the medical benefits account provide for reversion upon satisfaction of all liabilities (other than item "7" below)? Yes No _____
- h. Does the medical benefits account provide that forfeitures must be applied as soon as possible to reduce employer contributions to fund the medical benefits? Yes No _____

Appendix B: Rev. Proc. 2000-6 Section 420 Ruling Sections and Checklist

Section 2.04, of Revenue Procedure 2000-6, references changes for section 401(h) and 420 provisions. This section states that Section 16 has been modified to clarify the procedures for requesting determination letters on plan language that permits, pursuant to section 420, the transfer of assets in a defined benefit plan to a health benefit account described in section 401(h). Section 16 and the checklist in the Appendix of this revenue procedure have also been modified to reflect the amendments to section 420 that were made by section 535 of the Tax Relief Extension Act of 1999, Pub. L. 106-170 (TREA'99), which apply, generally, to qualified transfers occurring after December 17, 1999.

Section 16, of Revenue Procedure 2000-6, provides the following:

SCOPE

- .01 This section provides procedures for requesting determination letters
- (i) with respect to whether the requirements of section 401(h) are satisfied in a plan with retiree medical benefit features and
 - (ii) on plan language that permits, pursuant to section 420, the transfer of assets in a defined benefit plan to a health benefit account described in section 401(h).

REQUIRED INFORMATION FOR SECTION 420 DETERMINATION

.03 EP Determinations will consider the qualified status of plan language designed to comply with section 420 only if the plan sponsor requests such consideration in a cover letter.

The cover letter must specifically state

- (i) whether consideration is being requested only with regard to section 420, or

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- (ii) whether consideration is being requested with regard to section 420 in addition to other matters under section 401(a). (If consideration of other matters under section 401(a) is being requested, the application forms and other material required by this revenue procedure must also be submitted. Form 6406 may not be used for this purpose.)

The cover letter must specifically state the location of plan provisions that satisfy each of the following requirements. Parts I and II of the checklist in the Appendix of this revenue procedure may be used to identify the location of relevant plan provisions.

- (1) The plan must include a health benefits account as described in section 401(h).
- (2) The plan must provide that transfers shall be limited to transfers of "excess assets" as defined in section 420(e)(2).
- (3) The plan must provide that only one transfer may be made in a taxable year. However, for purposes of determining whether the rule in the preceding sentence is met, a plan may provide that a transfer will not be taken into account if it is a transfer that:
 - (a) Is made after the close of the taxable year preceding the employer's first taxable year beginning after December 31, 1990, and before the earlier of (i) the due date (including extensions) for the filing of the return of tax for such preceding year, or (ii) the date such return is filed; and
 - (b) Does not exceed the expenditures of the employer for qualified current retiree health liabilities for such preceding taxable year.
- (4) The plan must provide that the amount transferred shall not exceed the amount which is reasonably estimated to be the amount the employer will pay out (whether directly or through reimbursement) of the health benefit account during the taxable year of the transfer for "qualified current retiree health liabilities", as defined in section 420(e)(1).
- (5) The plan must provide that no transfer will be made after December 31, 2005.
- (6) The plan must provide that any assets transferred, and any income allocable to such assets, shall be used only to pay qualified current retiree health liabilities for the taxable year of

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transfer.

- (7) The plan must provide that any amounts transferred to a health benefits account (and income attributable to such amounts) which are not used to pay qualified current retiree health liabilities shall be transferred back to the defined benefit portion of the plan.
- (8) The plan must provide that the amounts paid out of a health benefits account will be treated as paid first out of transferred assets and income attributable to those assets.
- (9) The plan must provide that the accrued pension benefits for participants and beneficiaries must become nonforfeitable as if the plan had terminated immediately prior to the transfer (or in the case of a participant who separated during the 1-year period ending on the date of transfer immediately before such separation). In the case of a transfer described in section 420(b)(4) that relates to a prior year, the plan must provide that the accrued benefit of a participant who separated from service during the taxable year to which such transfer relates will be recomputed and treated as nonforfeitable immediately before such separation.
- (10) The plan must provide that a transfer will be permitted only if each group health plan or arrangement under which health benefits are provided contains provisions satisfying section 420(c)(3). The plan must define "applicable employer cost", "cost maintenance period", and "benefit maintenance period", as applicable, consistent with section 420(c)(3), as amended by TREA '99. If applicable, the provisions of the plan must also reflect the transition rule in section 535(c)(2) of TREA '99. The plan may provide that section 420(c)(3) is satisfied separately with respect to individuals eligible for benefits under Title XVIII of the Social Security Act at any time during the taxable year and with respect to individuals not so eligible.
- (11) The plan must provide that transferred assets cannot be used for key employees (as defined in section 416(i)(1)).

APPENDIX/CHECKLIST

As part of a section 401(h) or section 420 determination letter request described in section 16 of this revenue procedure the following checklist may be completed and attached to the determination letter request. If the request relates to section 401(h)

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but not to section 420, complete Part I only. If the request relates to section 420, complete Parts I and II (Part I is contained in Appendix A of this text).

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PART II

2. Does the Plan limit transfers to "Excess Assets" as defined in section 420(e)(2) of the Code? Yes No _____
3. Does the Plan provide that only one transfer may be made in a taxable year (except with regard to transfers relating to prior years pursuant to section 420(b)(4) of the Code)? Yes No _____
4. Does the Plan provide that the amount transferred shall not exceed the amount reasonably estimated to be paid for qualified current retiree health liabilities? Yes No _____
5. Does the Plan provide that no transfer will be made after December 31, 2005? Yes No _____
6. Does the Plan provide that transferred assets and income attributable to such assets shall be used only to pay qualified current retiree health liabilities for the taxable year of transfer? Yes No _____
7. Does the Plan provide that any amounts transferred (plus income) that are not used to pay qualified current retiree health liabilities shall be transferred back to the defined benefit portion of the Plan? Yes No _____
8. Does the Plan provide that amounts paid out of a health benefits account will be treated as paid first out of transferred assets and income attributable to those assets? Yes No _____
9. Does the Plan provide that participants' accrued benefits become nonforfeitable on a termination basis (i) immediately prior to transfer, or (ii) in the case of a participant who separated within 1 year before the transfer, immediately before such separation? Yes No _____
10. In the case of transfers described in section of 420(b)(4) the Code relating to 1990, does the Plan provide that benefits will be recomputed and become Yes No _____

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nonforfeitable for participants who separated from service in such prior year as described in section 420(c)(2)?

11. Does the Plan provide that transfers will be permitted only if each group health plan or arrangement contains provisions satisfying section 420(c)(3) of the Code, as amended by TREA '99? Yes No _____
12. Does the Plan define "applicable employer cost", "cost maintenance period" and "benefit maintenance period", as needed, consistently with section 420(c)(3) of the Code, as amended by TREA '99? Yes No _____
13. Do the Plan's provisions reflect the transition rule in section 535(c)(2) of TREA '99, if applicable? Yes No _____
14. Does the Plan provide that transferred assets cannot be used for key employees? Yes No _____

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Appendix D: Cafeteria Plan Technical Advisor Team

Abba Rabbani
Cafeteria Plan Technical Advisor
(972) 308-1587

Jay Jensen
Associate Cafeteria Plan Technical Advisor
(972) 308-7034
4050 Alpha Road
MC 4300 MSRO
Dallas, Texas 75244
Fax (972) 308-1545

Harry Beker, Chief, Health & Welfare Branch (TE/GE), Chief Counsel
(202) 622-6080

Felix Zech, Attorney, Health & Welfare Branch (TE/GE), Chief Counsel
(202) 622-6080

Christine Keller, Attorney, Health & Welfare Branch (TE/GE), Chief
Counsel
(202) 622-6080

Janet Laufer, Attorney, Health & Welfare Branch (TE/GE), Chief Counsel
(202) 622-6080

Judith M. Picken, Area Counsel (TE/GE) (GL/GC)
(312) 886-9225 x337

Munir Ebeid, Appeals Technical Advisor
(972) 308-7493