DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

C. Crouch
CC:TEGE:EB:QP1

MAR 14 2005

MEMORANDUM FOR PAUL T. SHULTZ, DIRECTOR
EMPLOYEE PLANS DETERMINATIONS REDESIGN

FROM: Janet Laufer JAL
Senior Technician Reviewer, CC:TEGE:EB:HW

SUBJECT: Request for Assistance (401(h) subordination limit)

Company =

Plan =

401(h) Account =

Date X =

Date Y =

**Background**

In your memorandum dated December 3, 2004, you requested our views as to three issues regarding the subordination limit of section 401(h)(1) of the Code. Your request was in response to three rulings requested by the Company with respect to the 401(h) Account for its Plan.

Section 401(h)(1) of the Code permits the establishment of an account in a pension plan qualified under section 401(a) to pay for medical expenses of retired employees, their spouses or dependents. Among other requirements, section 401(h)(1) requires that the benefits provided by such account must be subordinate to the retirement benefits provided by the plan. The flush language of section 401(h) further provides that "in no event shall the requirement of paragraph (1) be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance 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 was established."

The Plan is a defined benefit pension plan intended to be qualified under section 401(a) of the Code. The first day of the Plan's plan year is January 1 and January 1 is also the

Plan's valuation date. Effective as of Date X, the Plan was amended to add the 401(h) Account. The amendment was actually executed later in the plan year, on Date Y. The Company acknowledges that Date Y is the date of establishment of the 401(h) Account.

The Company requests the following rulings regarding the subordination limit:

(1) Contributions to the 401(h) Account under the Plan will be subordinate to the retirement benefits provided under the Plan if the contributions to the account, when aggregated with any contributions to fund retiree life insurance benefits, do not exceed 25% of the total contributions to the Plan on or after Date Y, other than contributions to fund past service credit, where past service credit is determined as the amount of any retirement contribution in excess of current liability normal cost. Current liability normal cost for this purpose means the expected increase in current liability due to benefits accruing during the plan year, calculated in accordance with section 412(*l*)(2)(C) of the Code.

(2) For purposes of determining the amount contributed to the Plan on or after Date Y, to fund current liability normal cost, all contributions to fund current liability normal cost for the plan year that contains Dates X and Y, shall be included, provided such contributions are made to the Plan on or after Date Y.

(3) For purposes of determining the amount of contributions that can be made to the 401(h) Account for plan years that begin after Date Y, the 25 percent limitation under the subordination test will be applied based on the lesser of (i) the aggregate contributions made to the Plan on or after Date Y, and (ii) the cumulative current liability normal cost incurred under the Plan subsequent to the effective date of the Plan, which is Date X. The amount so determined, less any contributions made to the 401(h) Account with respect to the plan year that contains Dates X and Y, would be the basis for the maximum contribution that could be made to the 401(h) Account for the first plan year beginning after Date Y.

Your office proposes to grant the Company's first ruling request, but proposes to deny the second and third requests.

The effect of the first ruling request is to allocate plan contributions for any plan year as first being made to fund current liability normal cost, and second to fund past service credit (but only to the extent that plan contributions exceed current liability normal cost for the plan year).

Your office's concern with the second ruling request is that it alters the allocation rule established under the first ruling request in the case of a section 401(h) account that is established on a day other than the first day of a plan year. The effect of the second ruling request is that post-establishment contributions are treated as first funding current liability normal cost even if pre-establishment contributions for the plan year have exceeded the plan year's current liability normal cost. Your office believes that a pro-rata allocation is more appropriate for the first year in which a section 401(h) account is established. Specifically, your office proposes that post-establishment contributions should be prorated according to the following formula: amount of plan year contributions made post-establishment of the section 401(h) account multiplied by the ratio of (i) current liability normal cost for the plan year to (ii) total contributions to the plan for the plan year.

Your office's concern with the third ruling request is that it permits carryover from year to year of unfunded cumulative liability normal costs. For example, if the Plan has current liability normal costs of $100 in plan years 1, 2, and 3, and the Company contributed $100 to the Plan in plan year 1, $0 in plan year 2, and $150 in plan year 3, under the Company's third ruling request, the 25 percent test would be based on $250 (which is the lesser of the aggregated $300 current liability normal cost and $250 in actual contributions). Your office believes that any unfunded current liability normal cost becomes a past service cost (or credit) in future years for purposes of the subordination limit.

The Company's concern with your office's position with respect to the third ruling request is that under such an approach the maximum amount that could be contributed to a section 401(h) account would fluctuate widely, depending on the plan sponsor's pattern of funding current liability normal cost, which in turn is heavily dependent on business cycles and cash flow predictability.

## Conclusion

For the reasons discussed below, we agree with your proposed responses to the Company's three ruling requests.

## Discussion

1. Legislative History. The 25 percent test now set forth in the flush language of section 401(h) of the Code was originally promulgated in final regulations issued in 1964:

> 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.

*See* T.D. 6722 (April 14, 1964), 29 F.R. 5072 (April 14, 1964); Treas. Reg. § 1.401-14(c)(1)(i).

Section 401(h) was added to the Code by § 2(a) of P.L. 87-863. Section 401(h), as originally enacted, contained a general requirement that medical benefits provided by a pension plan qualified under section 401(a) be subordinate to retirement benefits provided by the plan, but the legislative history did not specify a specific subordination test other than a general facts and circumstances test. H. Rep. 2317, *reprinted in* 1962-3 C.B. 1205, at 1207 ("Thus, if it is obvious from all the facts and circumstances that the real purpose of the plan is to provide medical, etc., benefits rather than pension benefits, the plan will not qualify under section 401 of the code."). [redacted]

Congress codified the 25 percent test in 1989. § 7311(a) of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239. This codification was due to the Service's position, as described in GCM 39785 (April 3, 1989), that the regulatory 25 percent test set forth in T.D. 6722 could reasonably be interpreted as permitting, in the case of a fully funded plan, section 401(h) account contributions of up to 25 percent of the normal cost of the plan (as opposed to 25 percent of the actual contributions to the plan, excluding contributions to fund past service liability). H. Rep. 101-247, *reprinted in* 1989 USCAAN 1906, at 2752; H. Conf. Rep. 101-386, *reprinted in* 1989 USCAAN 3018, at 3189. In codifying the 25 percent test, Congress indicated

> [GCM 39785] 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 section 401(h) accounts above what is permitted under present law and this provision."

H. Rep. 101-247, *reprinted in* 1989 USCAAN 1906, at 2753; *see also*, H. Conf. Rep. 101-389, *reprinted in* 1989 USCAAN 3018, at 3189. Thus, the legislative history indicates that Congress intended the subordination limit to fluctuate depending on the plan sponsor's actual pattern of funding the plan (excluding contributions to fund past service credit).

2. Regulatory Context of T.D. 6722. T.D. 6722 does not define the term "past service credits", nor does the regulation or preamble to the regulation explain why contributions to fund past service credits should be excluded from the 25 percent test. T.D. 6722 also does not provide rules detailing how plan contributions should be allocated between amounts that fund past service credits and amounts that do not. However, other regulations in effect at the time T.D. 6722 was issued do provide a framework for resolving these issues.

a. Third ruling request. The plan funding rules in effect at the time T.D. 6722 was issued indicate that the funding of past service credit was a reference to past service liability or cost. Furthermore, such rules indicate that the determination of past service liability or cost was made on an annual basis, and that unfunded normal cost of a prior year would become past service liability cost in future years. Thus, it is consistent with the intent of T.D. 6722 to deny the Company's third ruling request since the requested ruling has the effect of carrying forward unfunded normal costs to future years.

Specifically, at the time T.D. 6722 was issued, the section 404 limitation on the deduction of pension plan contributions required annual certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Treas. Reg. § 1.404(a)-4(b). The regulation provided that this amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year, and that such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Treas. Reg. § 1.404(a)-4(b). In turn, the section 404(a)(1)(C) regulation provided that normal cost for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc. had been fulfilled. Treas. Reg. § 1.404(a)-6(a)(2). The regulation defined past service or supplementary cost as the amount at any time which actuarially would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under such plan at such time. Treas. Reg. § 1.404(a)-6(b)(2). It is clear from the foregoing definitions that normal cost and past service credit/cost were concepts that were determined on an annual basis, and that an unfunded normal cost for a prior year would become a past service liability cost for future years.

b. First ruling request. T.D. 6722 does not specify how contributions are to be allocated between those contributions intended to fund past service credits and contributions that are not so intended. However, it is consistent with the regulatory context of T.D. 6722 to approve an allocation method that assumes that contributions are first intended to fund liabilities other than past service credit liabilities, and thus it is appropriate to approve the Company's first ruling request.

At the time T.D. 6722 was issued, the section 412 minimum funding rules had not yet been enacted. However, as part of a vesting rule safe harbor, annual contributions generally were required to be made to a pension plan in an amount sufficient to pay the liabilities of the plan created currently (i.e., the normal pension costs) plus the interest due on unfunded accrued pension liabilities (past service costs). *See* H. Rep. 93-807, *reprinted in* 1974 USCAAN 4670, at 4738.[1] Given such a rule, it is consistent with the regulatory context of T.D. 6722 to assume that contributions within a plan year are first allocated to the normal cost of the plan.

[redacted]

[1] Under the rules that accelerate the vesting of pension plan benefits in the case of a plan termination or complete discontinuance of plan contributions, a suspension of contributions to a pension plan does not constitute a discontinuance if, among other conditions, the unfunded past service cost at any time (which includes the unfunded prior normal cost and unfunded interest on any unfunded cost) does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment. Treas. Reg. § 1.401-6(c)(2)(ii). As noted by the Service and the Fifth Circuit, this vesting rule creates a safe harbor requiring payment of normal cost plus interest on past service costs unless a surplus was contributed to the plan in prior years. *See* GCM 36813 (August 16, 1976); *Subscription Television, Inc. v. Commissioner*, 532 F.2d 1021, 1028 (5th Cir. 1976).

[redacted]

If you have any questions regarding this memorandum, please call me at extension