



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200550043

SEP 22 2005

SEP. T. EP. RA. T. A1

Company =

Plan =

401(h) Account = the retiree medical account established pursuant to section
401(h) of the Code under the Plan

DATE 1 =

DATE 2 =

DATE 3 =

DATE 4 =

AMOUNT 1 =

AMOUNT 2 =

AMOUNT 3 =

AMOUNT 4 =

This letter is in response to your request for rulings that:

- (1) contributions to the 401(h) Account under the Plan will be subordinate to the retirement benefits provided under the Plan within the meaning of Code section 401(h)(1), if the contributions to the 401(h) Account, when aggregated with any contributions to fund retiree life insurance benefits, do not exceed 25 percent of the total contributions to the Plan on or after DATE 2, 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 2 to fund current liability normal cost, all contributions to fund current liability normal cost for the Plan year ended December 31, [REDACTED] shall be included, provided such contributions are made to the Plan on or after DATE 2.
- (3) For purposes of determining the amount of contributions that can be made to the 401(h) Account for the [REDACTED] plan year and thereafter, 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 2, and (ii) cumulative current liability normal cost incurred under the Plan subsequent to the January 1, [REDACTED] effective date of the 401(h) Account. The amount so determined, less any contributions made to the 401(h) Account with respect to the plan year ended December 31, [REDACTED] would be the basis for the maximum contribution that could be made to the 401(h) Account for [REDACTED]

Facts

The Plan is a defined benefit plan, intended to be qualified under section 401(a) of the Code. The Plan most recently received a favorable determination letter from the service dated October 23, 2000. Effective, January 1, [REDACTED] the Plan was amended to add the 401(h) Account. The amendment was executed on behalf of the Company on DATE 2, a date in calendar year [REDACTED] subsequent to January 1, [REDACTED]

For purposes of determining the portion of any contribution to fund retirement benefits made on or after DATE 2 that is not attributable to past service credit, the Company proposes to use the Plan's current liability normal cost, without regard to life insurance benefits provided through the Plan, for the Plan year for which the contribution is being made. "Current liability normal cost" for this purpose will mean 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. The amount of the current liability normal cost for the 2003 plan year so calculated is approximately AMOUNT 2.

The sole contribution the Company made to the Plan prior to DATE 2 for the 2003 plan year was a contribution of AMOUNT 1 on DATE 1. The sole contribution the Company made to the Plan to fund retirement benefits on or after DATE 2 for the [REDACTED] plan year was a contribution of AMOUNT 3 on DATE 3, a date in calendar year [REDACTED]. The sole contribution the Company made to the 401(h) Account for the [REDACTED] plan year was a contribution of AMOUNT 4 on DATE 4, a date in calendar year [REDACTED], subsequent to DATE 3.

Law

Section 401(h) of the Code permit a pension plan to provide for the payment of benefits for medical expenses of retired employees, their spouses, and their dependents, provided certain requirements are met. Section 401(h)(1) provides that medical benefits provided by the plan be subordinate to the retirement benefits provided by the plan.

Section 1.401-14(c)(1)(i) of the regulations provides 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 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.

Internal Revenue Service General Counsel Memorandum (GCM 39785) issued March 24, 1989, concludes that the substitution of "cost" for "contributions" in the test of Treas. Reg. 1.401-14(c)(1)(i) will permit accurate determination of the degree of subordination of the 401(h) benefits as compared to the pension benefits provided by the plan.

The Omnibus Reconciliation Act of 1989 (OBRA '89), however, 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 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 Committee report for OBRA' 89 states that "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 a section 401(h) account above what is permitted under present law and this provision."

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.

Issue (1)

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).

Section 1.401-14 of the regulations 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 would not be inconsistent with the regulatory context of section 1.401-14 to conclude that contributions within a plan year are first allocated to the normal cost of the plan. See section 1.401-6(c)(1) which provides that, 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.

Accordingly, the Plan may determine past service credit for a plan year, for the purpose of satisfying the subordination test of section 401(h) of the Code, as the amount of any retirement contributions in excess of the current liability normal costs for the plan year.

Issue (2)

The effect of the second ruling request is to alter 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 the plan year. The effect is that post-establishment contributions are treated as first funding current liability normal costs even if pre-establishment contributions for the plan year have exceeded the plan year's current liability normal cost.

The Code and regulations do not specify how normal costs are to be allocated within a year in the case of a mid-year establishment of a 401(h) account. However, it would be inconsistent with Congress' codification of the 25 percent test to permit, in the year of establishment of a 401(h) account, pre-establishment contributions to first fund past service costs and post-establishment contributions to first fund other than past service costs. To permit such, would, in effect, permit the retroactive establishment of a section 401(h) accounts, as a plan could, for example, merely contribute, subsequent to the establishment of the account, an amount equal to the normal cost and achieve the same effect as if the account had been established on the first day of the plan year.

Two reasonable methods of allocating normal costs in the year of (mid-year) establishment of a section 401(h) account are as follows. A plan could allocate the normal cost of the plan based on the ratio of post-establishment plan contributions to total plan contributions. Although this method would allow a plan to manipulate the subordination limit to a certain extent, this method is not inconsistent with Congressional intent of a subordination limit that fluctuates with the actual pattern of plan funding.

Alternatively, a plan could allocate the normal cost on the basis of time. For example, the post-establishment normal cost could be determined by multiplying the normal cost for the plan year in which the section 401(h) account is established by the ratio of the number of days remaining in the plan year after the establishment of the account to the total number of days in the plan year. In the instant case, the contribution of AMOUNT 4 to the 401(h) Account would be subordinate if the Plan normal cost was allocated on the basis of time.

Issue 3

The effect of the third ruling request is to permit carryover from year to year of unfunded cumulative current 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 third ruling request, the 25 percent test would be based on \$250 (which is the lesser of the aggregate \$300 current liability normal cost and \$250 in actual contributions).

The Code and regulations do not define the term "past service credit". However, the plan funding rules in effect at the time section 1.401-14 of the regulations 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.

Specifically, at the time section 1.401-14 of the regulations 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 under the plan. See section 1.404(a)-4(b) of the regulations. That regulation provides that this amount may be determined as (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).

Section 1.404(a)-6(a)(2) of the regulations, in turn, provides 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. That section further provides that past service or supplementary cost at any time is the amount actuarially determined which 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 employer contributions with respect to the employees covered under the plan at such time.

Accordingly, the Plan is not permitted to carry over unfunded cumulative current liability normal cost for the purposes of satisfying the subordination test of section 401(h) of the Code.

Conclusions

- (1) Contributions to the 401(h) Account under the Plan will be subordinate to the retirement benefits provided under the Plan within the meaning of Code section 401(h)(1), if the contributions to the 401(h) Account, when aggregated with any contributions to fund retiree life insurance benefits, do not exceed 25 percent of the total contributions to the Plan on or after DATE 2, other than contributions to fund past service credit, where past service credit is determined as the amount of any retirement contribution in excess of cumulative current liability normal costs incurred and funded on or after DATE 2. Current liability normal cost for this purpose is 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 2 to fund current liability normal cost, contributions to the Plan for the Plan year ended December 31, [REDACTED] made on or after DATE 2 may be included to the extent that such contributions are allocated to current liability normal costs based on either the ratio of post-establishment Plan contributions to total Plan contributions or on the basis of time as described above.
- (3) For purposes of determining the amount of contributions that can be made to the 401(h) Account for the [REDACTED] plan year and thereafter, the 25 percent limitation under the subordination test must be applied based on the cumulative current liability normal cost under the Plan incurred and funded on or after the DATE 2 establishment date of the 401(h) Account.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others as precedent.

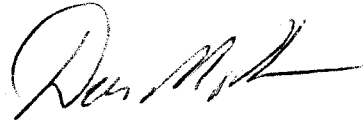
A copy of this letter is being furnished to your authorized representative pursuant to a power of attorney (Form 2848) on file. Copies of this letter are also being sent to the Manager, Employee Plans Classification in [REDACTED] and to the Manager, Employee Plans Compliance Unit in [REDACTED].

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If you have any questions on this ruling letter, please contact

Sincerely,

A handwritten signature in black ink, appearing to read "Donna Prestia", written in a cursive style.

Donna Prestia, Manager
Employee Plans Actuarial Group 2