The 401(h) Account

A Comprehensive Guide to Tax-Advantaged Retiree Medical Benefits

Introduction

This guide explores the mechanics, benefits, and regulatory considerations surrounding 401(h) accounts to help business owners and professionals maximize their tax savings while providing essential healthcare benefits.

1. What Is a 401(h) Account?

A **401(h) account** is a tax-advantaged **separate medical reimbursement account** that can be established within a **defined benefit plan** (such as a traditional pension plan or a cash balance plan). Under **the Internal Revenue Code (IRC)** §401(h), employers can set aside **tax-deductible funds** to cover **post-retirement medical expenses** for employees, their spouses, and dependents.

According to IRC §401(h) and Treas. Reg. §1.401-14(a), contributions to a 401(h) account:

- Must be subordinate or incidental to the pension benefits under the plan.
- Must be used for the payment of qualified medical expenses.
- Cannot revert back to the employer unless the plan is terminated, and all liabilities are satisfied.
- Must not exceed 25% of the total employer contributions to the pension plan (IRC §401(h)(2)).

2. How Does a 401(h) Account Work?

A 401(h) account operates as a separate component within a defined benefit plan, allowing employers to make tax-deductible contributions for future retiree medical expenses. Here's how it works:

- **Employer Contributions:** Employers fund the account through pre-tax contributions, which are fully deductible under IRC §162 and §401(h).
- **Tax-Free Growth:** Funds in the account grow tax-deferred over time.
- **Tax-Free Distributions:** Retirees and eligible dependents can withdraw funds tax-free to pay for qualified medical expenses under IRC §§105 and 106.
- **Subordination Rule:** Contributions to the 401(h) account must remain below 25% of the total employer contributions to the pension plan (IRC §401(h)(2)).
- **Reallocation Upon Plan Termination:** If the pension plan is terminated and all liabilities are met, any remaining funds in the 401(h) account may be reallocated to the pension trust or used for other eligible plan purposes (Treas. Reg. §1.401-14(c)(3)).
- **Distribution Restrictions:** The funds cannot be used for non-medical expenses and must only be used for expenses permitted under IRC §105 and §106.
- **Required Plan Documentation:** Employers must ensure that the plan document explicitly states the provisions of the 401(h) account to comply with IRS and ERISA requirements.

3. Why Should You Have a 401(h) Account?

A 401(h) account offers several financial and tax benefits:

Significant Tax Savings: Contributions are 100% tax-deductible to the employer.

Retirement Security: Helps cover post-retirement healthcare costs, reducing the financial burden on retirees.

Tax-Free Medical Benefits: Distributions for qualified medical expenses are tax-free for retirees and eligible dependents (IRC §§105 and 106).

Employer Recruitment & Retention: Enhances employee benefits, making retirement plans more attractive to key employees.

Increased Retirement Contributions: A 401(h) account allows additional tax-deductible contributions beyond traditional retirement plan limits.

Cost Management: Helps employers manage long-term healthcare liabilities while offering a tax-efficient retirement benefit.

Asset Protection: Funds in a 401(h) account are generally protected from creditors, offering financial security.

4. Who Is Eligible to Have a 401(h) Account?

A 401(h) account can be established by any employer who sponsors a qualified defined benefit plan. This includes:

- **Corporations (C-Corps & S-Corps)**
- **Sole Proprietors**
- **Partnerships & LLCs**
- **Professional Service Firms (Doctors, Dentists, Attorneys, etc.)**

5. When Can I Start Using a 401(h) Account?

Funds in a 401(h)-account become available for tax-free medical reimbursements upon the participant's retirement. An individual is considered retired for purposes of using 401(h) funds if they:

- Have reached normal retirement age as defined by the plan (Treas. Reg. §1.401-14(b)(1)).
- Have separated from service or become permanently disabled as determined by the employer.

6. Who Is Eligible to Use a 401(h) Account?

Under **IRC §§105 and 106, 401(h)** funds can be used for:

- The **retired employee**
- The retiree's **spouse**
- The retiree's **dependents**
- **Surviving spouses & dependents** (post-retirement death benefits)

7. Sample List of Benefits Provided Under IRC §§105 & 106

Eligible Medical Expenses	IRC Section
Health insurance premiums	§105
Medicare Part B & D premiums	§105
Prescription medications	§106
Long-term care insurance	§106
Dental and vision care	§105
Out-of-pocket deductibles	§105
Hospital & surgical expenses	§105
Home healthcare services	§106
Nursing home care	§106
Mental health services	§105
Chiropractic care	§105
Durable medical equipment	§106

8. What Happens to a 401(h) Account If the Pension Plan is Terminated?

Reallocation of Funds: If the plan is terminated, any remaining 401(h) funds must be used to satisfy existing retiree medical benefits before being reallocated under Treas. Reg. §1.401-14(c)(3).

No Employer Reversion: Funds cannot revert back to the employer unless all liabilities are satisfied.

Possible Plan Transfer: In some cases, funds may be transferred to another qualified plan with a similar retiree medical benefit structure.

Forfeiture Risks: If a plan is terminated and there are no remaining eligible beneficiaries, funds could be forfeited in accordance with plan rules.

Compliance and Reporting Requirements

01.

Employers must follow nondiscrimination rules under IRC §401(a)(4) and §410(b) to ensure equitable benefits for all eligible employees.

02.

Annual Form 5500 filings must include disclosures on 401(h) contributions and distributions.

03.

Plan administrators must provide summary plan descriptions (SPDs) and annual notices to plan participants about their rights and benefits under 401(h).