

Part I

Section 420.— Transfers of Excess Pension Assets to Retiree Health Accounts

26 CFR 1.420-1: Significant reduction in retiree health coverage during the cost maintenance period.

Rev. Rul. 2004-65

ISSUE

Has an employer reduced retiree health coverage, within the meaning of § 420(c)(3)(E) of the Internal Revenue Code, if an individual who has coverage for retiree health benefits (“covered individual”) accepts an offer from the employer to waive such coverage in exchange for enhanced pension benefits?

FACTS

Employer M maintains Plan X, a single-employer defined benefit plan qualified under § 401(a) of the Code with a plan year ending June 30. Plan X contains a retiree health benefits account that satisfies the requirements of § 401(h). Under Plan X, Employer M is permitted to make qualified transfers of excess pension assets, in accordance with § 420, to such account from time to time to fund applicable health benefits. On June 30, 2002, Employer M makes a qualified transfer of excess pension assets to the § 401(h) account. Effective July 1, 2004, Employer M offers to covered individuals the opportunity to receive enhanced pension benefits in return for waiving their applicable health benefits.

LAW AND ANALYSIS

Section 420(a) provides that if there is a qualified transfer of any excess pension assets of a defined benefit plan (other than a multiemployer plan) to a health benefits account which is part of such a plan, the related trust shall not be treated as failing to meet the requirements of § 401(a) or (h) solely by reason of such transfer. In addition, no amount shall be includible in gross income of the employer solely by reason of such transfer, and such transfer shall not be treated as an employer reversion for purposes of § 4980 or as a prohibited transaction for purposes of § 4975.

Among the requirements for a transfer to be a qualified transfer as defined in § 420(b) is that the minimum cost requirements of § 420(c)(3) must be satisfied. Section 420(c)(3)(A) provides, in relevant part, that each group health plan or arrangement under which applicable health benefits are provided must provide that the applicable employer cost for each taxable year during the cost maintenance period shall not be less than the higher of the applicable employer costs for each of the two (2) taxable years immediately preceding the taxable year of the qualified transfer. Section 420(c)(3)(B) defines applicable employer cost, and § 420(c)(3)(C) allows the minimum cost requirement to be applied separately with regard to individuals eligible for benefits under title XVIII of the Social Security Act. Under § 420(c)(3)(D), the cost

maintenance period is the period of five (5) taxable years beginning with the taxable year in which the qualified transfer occurs. Section 420(c)(3)(E) provides that the Secretary shall prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement.

Section 420(e)(1)(C) defines “applicable health benefits” to mean health benefits or coverage which are provided to (i) retired employees who, immediately before the qualified transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan, and (ii) their spouses and dependents.

Section 1.420-1 of the Income Tax Regulations provides guidance pursuant to § 420(c)(3)(E) regarding when an employer is considered to have significantly reduced retiree health coverage during the cost maintenance period. Section 1.420-1(b) provides, in general, that there is a significant reduction if, for any taxable year beginning on or after January 1, 2002, that is included in the cost maintenance period, either the employer-initiated reduction percentage for that year exceeds 10%, or the sum of the employer-initiated reduction percentage for that taxable year and all prior taxable years during the cost maintenance period exceeds 20%. The employer-initiated reduction percentage for any taxable year equals the number of individuals (retired employees plus their spouses and dependents) receiving coverage for applicable health benefits as of the day before the first day of the taxable year whose coverage for applicable health benefits ended during the taxable year by reason of employer action, divided by the total number of such individuals receiving coverage for applicable health benefits as of the day before the first day of the taxable year.

Section 1.420-1(b)(4) defines the term “employer action” for purposes of determining the employer-initiated reduction percentage. An individual’s eligibility for applicable health benefits ends during a taxable year by reason of employer action if, on any day within the taxable year, the individual’s eligibility for applicable health benefits ends as a result of a plan amendment or any other action of the employer (e.g., the sale of all or a part of the employer’s business) that, in conjunction with the plan terms, has the effect of ending the individual’s eligibility.

An employer’s offer to covered individuals to waive their retiree health benefit coverage in exchange for an incentive offered by the employer, such as enhanced pension benefits, is employer action under § 1.420-1(b)(4). Accordingly, if a covered individual accepts the offer to waive such coverage, the cessation of coverage will be treated as an employer-initiated reduction in coverage for purposes of determining whether the employer has significantly reduced retiree health coverage during the cost maintenance period.

HOLDING

An employer has reduced retiree health coverage, within the meaning of § 420(c)(3)(E), if an individual who has coverage for retiree health benefits (“covered individual”) accepts an offer from the employer to waive such coverage in exchange for enhanced pension benefits.

This ruling does not address other tax consequences that could arise from the offer.

DRAFTING INFORMATION

The principal author of this revenue ruling is Diane S. Bloom of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday, by calling (877) 829-5500 (a toll-free number). Ms. Bloom may be reached at (202) 283-9888 (not a toll-free number).