Department of the Treasury

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Person to Contact:

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Key

Taxpayer =

Fund =

Insurance Company =

M =

N =
O =
P =
date a =
$u to v =
$w =
$x =
$y =
$z =
c business =
d business =
e business =

Dear :

This is in response to letters dated October 2, 2001, and March 8, 2002, requesting rulings concerning the proposed transfer of funds from an insurance reserve fund to a voluntary employees' beneficiary association (VEBA) trust.

FACTS

Prior to date a, Taxpayer was the wholly owned subsidiary of Company M. On date a, Company M distributed its stock of the Taxpayer to Company M's public shareholders in a tax-free reorganization under section 368(a)(1)(D) of the Internal Revenue Code. As part of the reorganization, Taxpayer succeeded to all of the assets and reserves of an insurance reserve fund (the Fund) and assumed all of the liabilities of the Fund.

The Fund is a retired lives reserve under a group life insurance contact with Insurance Company. The Fund currently provides funding of life insurance benefits for retired employees and disabled employees of Taxpayer and of Company M. Under the terms of the insurance contract, the Fund can only be used to provide these life insurance benefits and cannot be withdrawn for any other purpose.

The Fund was created in 1974 by Company M to provide post-retirement life insurance coverage for employees of Company M above a certain grade level and other salaried employees of Company M at various locations and operating units. The life insurance benefits varied by operating units. In 1990, Company M added coverage for Company M employees on long-term disability. Since 1986, the Fund has paid only the first $50,000 of life insurance coverage for both the retired and disabled participants.

Between 1974 and 1985, Company M made annual contributions to the Fund ranging from approximately $u to $v. Since these deductions were made prior to the Deficit Reduction Act of 1984 (DEFRA), the contributions were deductible under section 162 of the Code but were not deductible under or limited by section 419, which was added to the Code by DEFRA and became effective in 1986. In 1986, Company M contributed $w to the RLR. By 1987, significant contributions were no longer needed because the actuarial liability was significantly lowered when benefits were scaled back to $50,000 after 1986. During 1994, 1995, and 1996, however, the RLR was in a deficit position, requiring Company M to make additional contributions of about $x in 1994 and in 1995 and $y in 1996. The Fund has also received an additional amount of about $z upon the recent demutualization of Insurance Company.

In 1996, as part of a corporate restructuring, Company N assumed the liabilities of the Fund attributable to Company M's retired employees involved in the c business and the assets allocable thereto. Also as part of a corporate restructuring, Company O succeeded to Company M's d business and, in 1997, assumed the liabilities of the Fund attributable to Company M and Company O's retired employees involved in the d business. Also as part of a corporate restructuring, Company P succeeded to Company M's e business and, in 1998, assumed the liabilities of the Fund attributable to Company M and Company P's retired employees involved in the e business.

As stated previously, on date a Taxpayer succeeded to all of the remaining assets and reserves of the Fund and assumed all of the remaining liabilities. Taxpayer represents that it does not have the right to recapture any portion of the assets of the Fund so long as any covered person remains alive.

Taxpayer now intends to transfer a portion of the assets and liabilities of the Fund to a VEBA trust that will be exempt under section 501(c)(9) of the Code. A fee will be paid to Insurance Company in order to effectuate the transfer. The Fund will continue to provide the life insurance benefits for disabled employees. Assets of the Fund that are not required to fund the coverage for the disabled employees and the Insurance Company fee will be transferred to the VEBA trust. Taxpayer plans to transfer to a Separate Account in the VEBA trust the portion of the assets attributable to Company M contributions made prior to 1986, to provide funding for medical benefits for Taxpayer's active employees. In addition, the Separate Account may be used to provide funding for medical benefits and life insurance benefits for the retired employees currently covered by the Fund. All assets of the Fund, other than those transferred to the Separate Account, will be used solely to provide funding for life insurance benefits for the retired employees currently covered by the Fund.

Taxpayer will determine (with the assistance of an actuary) the fair market value of the assets of the Fund and the value of all life insurance obligations of the Fund. All of the assets of the Fund are attributable to both pre-1986 and post-1985 contributions of Company M. (Taxpayer represents that no portion of the current assets of the Fund is attributable to contributions made by Taxpayer's employees or those of Company M.) The amount proposed to be transferred to the Separate Account of the VEBA trust will not exceed the amount attributable to Company M's pre-1986 contributions. Accordingly, an allocation between pre-1986 contributions and post-1986 contributions will be made with respect to the assets of the Fund, and only amounts attributable to pre-1986 contributions of Company M will be transferred to the Separate Account of the VEBA.

Taxpayer and its actuaries will use the following guidelines to determine the amounts attributable to pre-1986 contributions of Company M.

(1) As of December 31, 1985, the amount attributable to pre-1986 contributions by Company M will be equal to a pro-rata share of the then fair market value of assets in the Fund.

(2) As of the end of any subsequent taxable year, the amount attributable to pre-1986 contributions by Company M will be equal to the amount attributable to pre-1986 contributions as of the end of the previous taxable year, reduced by pro-rata benefit payments, pro-rata administrative expenses and other disbursements for the current taxable year, and increased by a pro-rata share of income (including realized and unrealized

gains and losses) for the taxable year determined as of the end of the current taxable year.

Taxpayer requests rulings with respect to the proposed transaction under sections 61 and 4976(b)(1)(C) of the Code.

LAW AND ANALYSIS

Section 61(a) of the Code provides that, unless otherwise excepted, gross income includes all income from whatever source derived.

Section 419 of the Code provides rules with respect to the tax treatment of "welfare benefit funds." Section 419(e)(1) defines the term "welfare benefit fund" to include any fund through which the employer provides welfare benefits to employees or their beneficiaries. The term "fund" is defined in section 419(e)(3) to include an organization described in section 501(c)(9) of the Code. The term "fund" is also defined in section 419(e)(3)(C) to include, to the extent provided in regulations, any account held for an employer by any person.

Section 1.419-1T(c), Q&A-3 provides that a retired lives reserve or a premium stabilization maintained by an insurance company is a "fund," or part of a "fund," if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years' benefits costs or insurance premiums.

Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund shall not be deductible under Chapter 1 of the Code, but if they would otherwise be deductible, shall be deductible under section 419 for the taxable year in which paid, but subject to the limitation of section 419(b).

Section 419(b) of the Code provides that the amount of the deduction for any taxable year shall not exceed the welfare benefit fund's "qualified cost" for the taxable year. Under section 419(c)(1), the term "qualified cost" means, with respect to any taxable year, the sum of (A) the "qualified direct cost" for such taxable year, and (B) subject to the limitation of section 419A(b), any addition to a "qualified asset account" for the taxable year. Under section 419(c)(2), the qualified cost for any taxable year is reduced by the fund's after-tax income for the taxable year.

Section 419(c)(3) of the Code defines "qualified direct cost" to mean, with respect to any taxable year, the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if (i) those benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting.

Section 419A(a) of the Code defines “qualified asset account” to mean any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) of the Code provides that no addition to any qualified asset account may be taken into account under section 419(c)(1)(B) to the extent such addition results in the amount in that account exceeding the account limit. Pursuant to section 419A(c)(1), except as otherwise provided in that subsection, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund (A) claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in subsection (a) of section 419A, and (B) administrative costs with respect to such claims.

Section 419A(c)(2) of the Code provides that the account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees.

Section 1.419A-1T, Q&A-2(a), of the regulations provides that section 419 of the Code generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date. Q&A-2(b) of that regulation provides a special transition rule for certain welfare benefit funds that are part of a plan maintained pursuant to one or more collective bargaining agreements, and Q&A-9 of that regulation provides special transition rules for the first taxable year of a fiscal year employer ending after December 31, 1985.

Section 4976(a) of the Code imposes an excise tax on an employer equal to 100% of any disqualified benefit provided by an employer-maintained welfare benefit fund.

Section 4976(b)(1)(C) of the Code provides that the term "disqualified benefit" includes any portion of a welfare benefit fund reverting to the benefit of the employer.

Section 4976(b)(3) of the Code provides that section 4976(b)(1)(C) shall not apply to any amount attributable to a contribution to a welfare benefit fund that is not allowable as a deduction under section 419 for the taxable year or any prior taxable year.

Rules concerning deductions for employer contributions to a retired lives reserves prior to the effective date of section 419 and 419A are found in Rev. Rul. 69-382, 1969-2 C.B. 28. Pursuant to that revenue ruling, for taxable years ending on or before June 17, 1969, premium paid or incurred by an employer policyholder under contracts providing group term life and health and accident coverage for its active and retired employees were deductible in full even though a portion of the premium was credited to a retired lives reserve if (1) the balance in the reserve was held by the insurance company solely for the purpose of providing insurance coverage on active and retired lives so long as any active or retired employee remained alive, and (2) the amount added to the retired lives reserve was not greater than the amount that would be required to fairly allocate the cost of the insurance coverage provided over the working lives of the employees involved. Further, the ruling holds that these conclusions would be applicable to taxable years ending after June 17, 1969, provided that the employer policyholder promptly amended the contract to provide that it did not retain any right to recapture any portion of the reserve so long as any active or retired employee remains alive.

We conclude that the proposed transaction will not result in an excise tax under section 4976(b)(1)(C) of the Code. The funds to be transferred to the VEBA trust to be used to provide medical benefits for active employees instead of retiree life insurance benefits are amounts solely attributable to pre-1986 contributions. Pursuant to section 4976(b)(3), an amount is not subject to section 4976(b)(1)(C) to the extent it is attributable to an employer contribution with respect to which no deduction is allowable under section 419 for the current or any prior taxable year. Since none of the funds that will be used for the active employees are attributable to deductions taken under section 419 of the Code, these amounts will not be treated as reverting to the benefit of the employer for purposes of section 4976(b)(1)(C) of the Code. With respect to amounts attributable to post-1985 contributions to be transferred to the VEBA trust, those assets will continue to be used to provide welfare benefits for retired employees, and there is no reason to view the proposed transaction as a reversion to the employer for purposes of the tax imposed by section 4976(b)(1)(C) of the Code.

Based on the information submitted, and the representations made therein, we rule that the proposed transaction will not cause Taxpayer to incur an excise tax under section 4976(b)(1)(C) of the Code.

As we have previously discussed with you, in the interest of sound tax administration, we are declining to rule on the issue of whether the transfer of the assets and liabilities of the Fund to the VEBA trust will result in the realization and recognition of gross income to the Taxpayer under section 61 of the Code. Please note, however, that if the proposed use of the VEBA assets does result in the realization and recognition of gross income to the Company under section 61, the Company would be entitled to an offsetting deduction under section 419 for the qualified direct costs of providing welfare benefits for the employees.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any provision of the Code.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

MARK SCHWIMMER
Senior Technican Reviewer
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)