TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: September 8, 2004

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Dear :

This is in response to a ruling request dated July 14, 2003, as supplemented by a letter dated February 9, 2004, from L's authorized representative, who has requested certain rulings relating to the tax consequences of a proposed transaction.

The information submitted shows that L ("Corporation") was formerly part of M. Corporation became independent of M following completion of a tax-free reorganization on .

In conjunction with the reorganization, Corporation established three voluntary employees' beneficiary association ("VEBA") trusts for funding postretirement life and health benefits. They were the Postretirement Life Insurance Benefits Trust, the Represented Employees Postretirement Health Benefits Trust, and the Management and Nonrepresented Employees Postretirement Health Benefits Trust. Those trusts were initially funded with assets transferred from corresponding welfare benefit funds maintained by M. Some of those assets were attributable to Pre- Deficit Reduction Act of 1984 ("DEFRA") contributions. Subsequently, those trusts were reconfigured into the trusts Corporation currently maintains.

Corporation currently provides life insurance and health benefits for its retired employees through a single employee welfare benefit plan (the "Postretirement Welfare Plan"). Corporation currently maintains four separate VEBA trusts for the purposes of funding its postretirement life insurance and health benefits:

(1) the Represented Welfare Trust which provides both life insurance and health benefit coverage to retirees who, prior to retirement, were represented employees.
(2) the Nonrepresented Welfare Trust which provides both life insurance and health benefit coverage to retirees who, prior to retirement, were nonrepresented employees.
(3) the Represented Health Trust which, in conjunction with the Represented Welfare Trust, provides postretirement health benefits to represented employees.
(4) the Nonrepresented Health Trust which, in conjunction with the Nonrepresented Welfare Trust, provides postretirement health benefits to nonrepresented employees.

All of these trusts are VEBAs described in section 501(c)(9) of the Internal Revenue Code. Corporation has no right to any of the assets held in any of these trusts.

Corporation proposes to amend two of the trusts, the Nonrepresented Welfare Trust and the Represented Welfare Trust, as well as certain group term life insurance policies held by those trusts, to permit all Pre-DEFRA Reserve amounts held by these trusts to be used to pay postretirement health benefit costs. The Pre-DEFRA Reserve amounts are all amounts held by those trusts that are attributable to the assets held in postretirement life insurance reserves as of December 31, , and are attributable to deductions taken prior to the effective date of section 419 of the Code. In PLR 200301047, the Service ruled that the use of certain Excess Pre-DEFRA Reserves held by those trusts to pay postretirement health benefits would not result in any inclusion in income to Corporation. In general, the Excess Pre-DEFRA Reserve was defined as the excess of the fair market value of assets held by a trust over the present value of that VEBA's benefit obligations. Under the new proposal, the terms of the Nonrepresented Welfare Trust and the life insurance policy it holds would be amended to provide that the entire Pre-DEFRA Reserve held under the policy's retired lives reserves may be applied toward the payment of postretirement health obligations for the nonrepresented employees. Similarly, the terms of the Represented Welfare trust and the policy it holds would be amended to provide that the entire Pre-DEFRA Reserve held under the policy's retired lives reserve may be applied toward the payment of postretirement health obligations for the represented employees. In addition, the trusts and insurance policies would incorporate provisions permitting any Pre-DEFRA Reserve amounts to be released from the retired lives reserve and deposited in a separate postretirement health benefit account within the trust. The amount of Pre-DEFRA Reserve that may be released for the retired lives reserve in any taxable year will be determined by Corporation on a day during such year that is not later than the actual release of such assets (if any). However, only an amount that would otherwise currently be deductible under section 419(a)(2) as a contribution to fund postretirement health benefits may be transferred to the health benefit account. Corporation will at no time have any right to receive assets of any retired lives reserve maintained pursuant to insurance policies held by any of these trusts.

Ruling Request 1:

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

Section 111(a) of the Code provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by Chapter 1 of the Code. That section, in part, codifies the "tax benefit rule."

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified at section 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983). Its purpose is to approximate the results produced by a tax system based on transactional rather than accounting. Id. at 381. The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. Id. at 381-383. One must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions. Id. at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See American Mutual Life Insurance Co. v. U.S., 267 F.3d 1344, 1350 (Fed. Cir. 2001).

Contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses under section 162 of the Code and only to the extent allowable under sections 419 and 419A. Those sections impose strict limits on the amount of tax-deductible prefunding permitted for contributions to a welfare benefit fund. The deduction limitations imposed by sections 419 and 419A apply to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985. Prior to this date deductions for contributions paid to welfare benefit funds were controlled by section 162.

Section 1.162-10 of the Income Tax Regulations provides, in part, that amounts paid or accrued within the taxable year for a sickness, accident, hospitalization, medical expense, or similar benefit plan, are deductible under section 162(a) of the Code if they are ordinary and necessary expenses of the trade or business.

Rev. Rul. 69-382, 1969-2 C.B. 28, holds that for taxable years ending on or before June 17, 1969, premiums paid or incurred by an employer policyholder under contracts providing group term life and health and accident coverage for its active and retired employees are deductible in full even though a portion of the premium is credited to a retired lives reserve if (1) the balance in the reserve is held by the insurance company solely for the purpose of providing insurance coverage on active or retired lives so long as any active or retired employees remain alive, and (2) the amount added to the retired lives reserve is not greater than an amount which would be required to fairly allocate the cost of the insurance coverage provided over the working lives of the employees involved. This revenue ruling also states that for taxable years ending after June 17, 1969, such premiums paid or incurred are deductible if in addition to the two requirements, the insurance contract states that the employer policyholder has no right to recapture any portion of the reserve so long as any active or retired employee remains alive.

Rev. Rul. 69-478, 1969-2 C.B. 29, holds that a taxpayer’s nonrefundable contribution to an employee’s trust to provide group health and life insurance for both active and retired employees is deductible under section 162 of the Code when contributions are actuarially determined and made by the employer on a level basis so that at the time of an employee’s retirement there is enough money in the fund to enable the trustee to continue to make premium payments on the contracted insurance.

Rev. Rul. 73-599, 1973-2 C.B. 40, holds that the annual contributions by the taxpayer to the fund maintained by the trustee for retired lives are business expenses deductible under section 162 of the Code in the taxable year paid or incurred but only to the extent that such contributions are actuarially determined and made on a level basis.

As stated above, the tax benefit rule is implicated when a taxpayer has taken a deduction in a prior year, and in a subsequent year an event occurs that is fundamentally inconsistent with the premise of the deduction. The facts and circumstances of each case must be considered “in light of the purpose and function of the provisions granting the deductions.” Hillsboro National Bank, 460 U.S. at 385.

The proposed transactions involve using assets attributable to amounts contributed prior to the applicability of section 419 of the Code. As such, deductions for these contributions would have been taken under section 162 for ordinary and necessary business expenses, limited by the rules set out in Rev. Rul. 69-382, Rev. Rul. 69- 478, and Rev. Rul. 73-599.

Under the proposal, assets originally contributed to a retired lives reserve to provide postretirement life insurance coverage for nonrepresented employees would be available to pay postretirement health benefits for nonrepresented employees (or to be released from the retired lives reserve and deposited in a separate account within the same VEBA to be used for that purpose). Similarly, assets originally contributed to a retired lives reserve to provide postretirement life insurance coverage for represented employees would be available to pay postretirement health benefits for represented employees (or to be released to a separate account within the same VEBA for that purpose). With respect to either VEBA, however, only an amount that would otherwise be currently deductible under section 419(a)(2) as a contribution to fund postretirement health benefits will be transferred to the health benefit account. (pursuant to section 419A(c)(12), those amounts are limited to a reserve funded over the working lives of the covered employees actuarially determined on a level basis for the postretirement medical benefits to be provided to covered employees.) The released funds would only be used for purposes of providing welfare benefits for retirees and L would have no right to recapture any portion of the assets held by the VEBAs.

For the deduction taken under section 162 for a contribution to a welfare benefit fund prior to the enactment of section 419, no distinction was made between the types of postretirement welfare benefits provided through the fund. Thus, the original deductions would not have been foreclosed merely because the reserve amounts could be used for postretirement medical as proposed. However, the deduction for those postretirement benefits was not unlimited – the contributions had to be for ordinary and necessary business expenses and the deductible amount was subject to the rules set out in Rev. Rul. 69-382, Rev. Rul. 69-478, and Rev. Rul. 73-599. Corporation has represented that it appears reasonable to conclude that all of the contributions toward the life insurance reserve would have been fully deductible under section 162 if the contributions to the postretirement life insurance reserve had in fact been made to the postretirement health reserve. Thus, the original deductions would not have been foreclosed had the proposed transactions occurred in the taxable year of the deductions. Moreover, this approach is in accord with the purpose and function of the law prior to the enactment of section 419. Accordingly, releasing assets in the retired lives reserves attributable to Pre-DEFRA amounts that were originally contributed to fund postretirement life insurance, in order to now fund postretirement health benefits, is not fundamentally inconsistent with the deductions taken in previous years with respect to those assets and, therefore, the inclusionary part of the tax benefit rule will not apply.

Ruling Request 2:

Section 4976(a) of the Code imposes a 100% excise tax if an employer maintains a welfare benefit fund, and there is a disqualified benefit provided during any taxable year.

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

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

Corporation represents that only amounts attributable to the Pre-DEFRA Reserve will be used to pay postretirement health benefits under the proposed transactions. The Pre-DEFRA Reserve is attributable solely to contributions that were not allowable as deductions under section 419. Thus, the transferred amounts are not subject to section 4976 excise tax.

Therefore, the proposed transactions will not result in the provision of any "disqualified benefit" within the meaning of section 4976 of the Code and, consequently, will not cause Corporation to be liable for the tax imposed by section 4976.

Ruling Request 3:

Corporation has represented that the retired lives reserve will be used exclusively to provide postretirement life insurance benefits and to pay related administrative expenses (excluding settlor expenses). Corporation has further represented that the funds in the reserve have never been used (and pursuant to this ruling request, would not be used) for any purpose other than providing postretirement benefits.

Therefore, the proposed transaction will not adversely affect the determinations in PLR 9701010.

Accordingly, we conclude as follows:

1. The proposed transactions will not cause Corporation to include any amount in gross income.

2. The proposed transactions will not result in the provision of any “disqualified benefit” within the meaning of section 4976 and, consequently, will not cause Corporation to be liable for the tax imposed by section 4976.

3. The proposed transactions will not adversely affect the determinations in PLR 9701010.

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

Sincerely,

Robert C. Harper

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3