Internal Revenue Service

Number: **200618025**
Release Date: 5/5/2006
Index Number: 61.00-00, 83.00-00, 111.00-00, 402.00-00, 677.00-00, 4976.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B02
PLR-165082-03

Date:
January 20, 2006

A =

B =

C =

Insurer =

State =

City =

Dear :

This letter responds to a letter dated November 6, 2003, and subsequent correspondence, submitted on behalf of A and C by their authorized representative, requesting certain rulings under the Internal Revenue Code.

The information submitted states that A is the chamber of commerce for the greater City area. A is classified as a tax exempt organization under § 501(c)(6). B is the small business division of A. Small business members of A (Enrolled Member Firms) purchase health care coverage through the B Health Program. Under the B Health Program, each Enrolled Member Firm sponsors and maintains its own group health plan that provides health coverage to employees and retirees (Subscribers) and to their spouses and dependents (who, with Subscribers, are Covered Persons).

C is a State nonprofit corporation that is a taxable corporation for federal income tax purposes. A is the sole voting member of C. C provides certain administrative services in connection with the B Health Program and a number of other A and B sponsored benefit programs. In connection with the B Health Program, C provides premium billing services through a third party administrator, provides premium collection and remittance services through a bank lock box program, negotiates the structure and features of the B Health Program with Insurer, monitors the operations of the B Health Program, provides educational materials and seminars concerning group health insurance coverage, and responds to Enrolled Member Firms that have questions about enrollment, disenrollment, premium levels, and other matters concerning the B Health Program.

Insurer is a non-life mutual health insurance company incorporated under the laws of State. Insurer and a subsidiary sell group health insurance and HMO products to small business members of A through the B Health Program.

In order to help hold down health insurance premium rates for the Enrolled Member Firms, Insurer and C agreed to create a "premium stabilization reserve" under the B Health Program, which will be known as the "Underwriting Management Fund" (UMF). Initially, the UMF will be held by Insurer and, if there is a positive cash balance in the UMF, it will be transferred to a trust (Trust) created by an agreement between C and an independent corporate trustee and initially funded by C with a nominal amount. C has the power to appoint members of the committee which may remove and replace the trustee and control the investments of Trust. The terms of Trust are intended to protect the UMF assets from the creditors of Insurer, and to assure that the UMF assets will be used for their intended purpose.

The B Health Program uses a contract year that begins on July 1 and ends the following June 30 (Contract Year). Each November, Insurer will determine whether it had an actual surplus or deficit from the B Health Program for the preceding Contract Year. If, for any completed year, Insurer receives earned premiums for all Enrolled Member Firms that result in a profit to Insurer in excess of 3%, the excess will be transferred to the UMF by Insurer. If Insurer suffers a deficit (i.e., does not earn a 3% profit) for a year, the deficit amount reduces the UMF balance and the amount of the deficit (up to the amount in the UMF) is transferred from the UMF to Insurer so that Insurer will have a 3% profit for the deficit year.

Under the terms of Trust, Insurer (which includes Insurer's subsidiary for Trust purposes) will transfer any positive balance in the UMF to Trust. Thereafter, in each November, when Insurer and C have agreed on the final calculations to determine whether Insurer had an actual surplus or deficit from the B Health Plan, Insurer will be obligated to transfer cash to Trust equal to the positive adjustment to the UMF (i.e., the surplus, plus interest), and Trust will be obligated to transfer cash to Insurer equal to the negative adjustment to the UMF (i.e., the deficit, plus interest).

C may annually elect to apply all or a portion of a positive adjustment amount with the balance then in the reserve to reduce standard insurance premium rates for the next Contract Year. If C makes the election to apply all or a portion of a positive adjustment amount to reduce the next Contract Year's standard premiums, one-twelfth of the elected amount is charged against the UMF and transferred from Trust to Insurer each month during the next Contract Year to the extent the UMF and Trust have a positive cash balance.

While Insurer participates in the B Health Program, the Trust assets can only be used to reduce future insurance premiums charged to the Enrolled Member Firms and to pay Trust expenses. Upon termination of Insurer's participation in the B Health Program, the Trust assets may only be used for: (1) paying or reducing future health insurance premiums with other health insurance carriers; (2) operating (including promotion and marketing activities) wellness, health, and educational programs for the benefit of the health interests of the Covered Persons, and (3) paying Trust expenses.

Upon termination of the B Health Program, under no circumstances will Trust assets be paid to or controlled by any Enrolled Member Firm. The Enrolled Member Firms have no control over (1) if, to what extent, and when, the premium adjustment mechanism will result in a cash payment by Insurer to Trust; (2) the investment of Trust assets; (3) if, to what extent, when, and how, Trust assets will be used; and (4) the terms of Trust. The Enrolled Member Firms who cease participation in the B Health Program completely cease participation in the premium adjustment mechanism, without any claim to or interest in Trust assets.

RULING 1

Section 641(a) provides, in general, that the tax imposed by § 1(e) shall apply to the taxable income of estates or of any kind of property held in trust.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 672(a) defines "adverse party," for purposes of subpart E, as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

Section 672(b) defines “nonadverse party”, for purposes of subpart E, as any person who is not an adverse party.

Sections 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as the owner of a portion of a trust.

Section 677(a)(1) provides, in general, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor’s spouse.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of part I of subchapter J, chapter 1, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) of property to a trust. For purposes of § 1.671-2(e)(1), the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under §§ 671 through 677 or 679.

Section 1.671-2(e)(2)(i) provides that a gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Section 1.671-2(e)(2)(ii) provides that for purposes of § 1.671-2(e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For purposes of this determination, an interest in the trust is not property received from the trust.

Section 1.671-2(e)(4) provides that if a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust.

Section 1.677(a)-1(c) provides that under § 677, the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively.

Rev. Rul. 85-13, 1985-1 C.B. 184, provides that a grantor who is treated as the owner of the entire trust under § 671 is treated as the owner of the trust assets for federal income tax purposes. Therefore, a transfer of assets between the grantor and the trust is not recognized as a sale or exchange.

Based solely on the facts and representations submitted, we conclude that while Insurer participates in the B Health Program, it will be treated as a grantor and as the owner of the Trust under §§ 671 and 677 because Insurer has made a gratuitous transfer to the Trust for a business purpose of Insurer and the income of the Trust may be, in the discretion of C (which is not an adverse party) distributed to Insurer. The Insurer will include in calculating its taxable income all of the income, deductions, and credits of the Trust. The Trust's receipt of contributions from the Insurer will not result in gross income to the Trust. We further rule that upon the termination of the B Health Program or Insurer ceasing to participate in the B Health Program, the Trust will cease to be treated as a grantor trust owned by Insurer, and will be treated as a taxable trust under § 641 to which the Insurer has transferred all of the assets of the Trust. The receipt of such assets will not result in any gross income to the Trust.

RULING 2

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived.

The Supreme Court has construed the term "income" for purposes of § 61(a) to include "undeniable accessions to wealth, clearly realized, over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Section 111(a) 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.

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 there occurs an event 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 § 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 National Bank v. Commissioner and

United States v. Bliss Dairy, Inc., 460 U.S. 370, 377 (1983). Its purpose is to approximate the results produced by a tax system based on transactional rather than annual 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. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

In the present case, the Enrolled Member Firms are not required under the tax benefit rule to include in income the amounts previously deducted as health insurance premiums pursuant to their participation in the B Health Program. First, there is no recovery of any portions of the previously paid premiums. The terms of Trust do not permit the refund or reversion of the previously paid premiums from Trust assets to the Enrolled Member Firms in later years. Moreover, the Enrolled Member Firms do not retain any right to direct payment of the Trust assets to another or to amend the terms of the Trust to have the Trust assets converted to them. The fact that Insurer is obligated to pay cash to Trust in certain circumstances, and that the Trust assets may be used to reduce future premium rates does not establish that the Enrolled Member Firms will recover any portions of the health insurance premiums they paid in previous years. Rather, the reduction in the premium amounts the Enrolled Member Firms are to pay to Insurer in the future years simply represents part of the parties' agreement as to the proper adjustment of the future premium rates.

Further, neither Insurer's transfer of cash to Trust nor the use of the Trust assets for the purposes permitted by the trust agreement constitutes an event that is fundamentally inconsistent with the premise on which the deduction was originally taken. The Enrolled Member Firms pay annual health insurance premiums to Insurer necessary to purchase coverage for the Covered Persons during the Contract Year, and take deductions for such payment as ordinary and necessary business expenses under § 162. Payments from and to the Trust in accordance with the terms of the trust agreement, including the computation of premium rates for the next Contract Year, are not inconsistent with, or unforeseen at the time of, the earlier deduction. They do not represent a return of previously deducted insurance premiums, but rather these adjustments comprise a mechanism for determining and stabilizing premium rates in future Contract Years. Moreover, if occurring during the same taxable year as the premium deduction, payments from and to the Trust would not reduce or foreclose the deduction for the premiums paid for that particular Contract Year. Therefore, neither Insurer's transfer of cash to Trust, nor the use of the Trust assets for the purposes permitted by the trust agreement, will cause the Enrolled Member Firms to realize gross income under the tax benefit rule.

We further conclude that the transfer of amounts by the Insurer to Trust and the use of Trust assets pursuant to the trust agreement do not give the Enrolled Member Firms accession to any portion of these amounts nor do the Enrolled Member Firms have direct control over these amounts by reason of their transfer or use. In addition, no part of the transferred amounts may be paid directly to the Enrolled Member Firms as a refund of premiums. Consequently, the amounts transferred by the Insurer to Trust and the use of Trust assets pursuant to the trust agreement will not result in gross income to the Enrolled Member Firms under § 61.

RULING 3

Section 4976 imposes an excise tax in the amount of 100 percent of the amount of any disqualified benefit provided by any welfare benefit fund maintained by an employer. Section 4976(b)(1)(C) provides that a "disqualified benefit" includes "any portion of a welfare benefit fund reverting to the benefit of the employer." Section 4976 was enacted in the Deficit Reduction Act of 1984. In connection with technical corrections enacted in 1986, the legislative history states: "[A] portion of a welfare benefit fund is not considered to revert to the benefit of the employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries." H. R. Rep. No. 426, 99th Cong., 1st Sess. (1985), 1986-3 C.B. (Vol. 2) at 985. See also S. Rep. No. 313, 99th Cong., 2d Sess (1986), 1986-3 C.B. (Vol. 3) at 1009.

Trust, a welfare benefit fund, provides benefits to Enrolled Member Firms' employees and their beneficiaries. Upon termination of Trust, no assets will be paid to or controlled by any Enrolled Member Firm. Thus, under the terms of Trust, no Trust assets will revert to any Enrolled Member Firm and there is no disqualified benefit as defined in § 4976(b)(1)(C). Therefore, neither Insurer's transfer of cash to Trust nor the use of Trust assets for the purposes permitted in the trust agreement will result in an excise tax under § 4976(b)(1)(C).

RULING 4

Section 83(a) provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over the amount (if any) paid for the property is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Section 1.83-3(e) provides that for purposes of § 83, the term "property" does not include an unfunded and unsecured promise to pay money or property in the future. However, the term "property" does include a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditors, for example, in a trust or escrow account.

Section 1.83-8(a) provides generally that § 83 applies to a transfer to or from a nonqualified trust for the benefit of employees, independent contractors, or their beneficiaries. To the extent such a transfer is subject to § 402(b), however, § 83 applies to the transfer only as provided for in §402(b).

Section 402(b)(1) provides that contributions made by an employer to an employees' trust that is not exempt from tax under § 501(a) are included in the employee's gross income in accordance with § 83, except that the value of the employee's interest in the trust is substituted for the fair market value of the property in applying § 83.

If Subscribers' interests are limited to the payment of benefits under the B Health Program and those benefits are otherwise excludible from the gross income of Subscribers (e.g., under § 105 or §106), contributions to Trust are not includible in the gross income of the Subscribers.

RULING 5

Section 61 provides that gross income means all income from whatever source derived.

The Supreme Court has construed the term "income" for purposes of § 61(a) to include "undeniable accessions to wealth, clearly realized, over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

In the present case, the transfer of amounts by the Insurer to Trust and the use of Trust assets pursuant to the trust agreement neither give A or C accession to any portion of these amounts, nor do A or C have direct control over these amounts by reason of their transfer or use. In addition, no part of the transferred amounts may be paid directly to A or C as a refund of premiums. Consequently, the amounts transferred by the Insurer to Trust and the use of Trust assets pursuant to the trust agreement will not be gross income, pursuant to § 61, to either A or C.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed concerning the tax consequences to any taxpayer upon the termination of the relationship between A and the Enrolled Member Firms. Further, no ruling is made or implied concerning the treatment of any person under subchapter L of chapter 1 of subtitle A (regarding insurance companies).

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the authorized representative of A and C.

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes