TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200641008**
Release Date: 10/13/06
Date:July 20, 2006

Contact Person:

Uniform Issue List: 213.04-00
414.07-00
419A.00-00
512.09-03

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Plan =

System =
State =
Statute =

Board =
y =

Dear

This responds to your letter requesting rulings under various sections of the Internal Revenue Code as described below.

The System, established under the Statute, provides pension benefits to its members, who are police officers and firefighters employed by participating political subdivisions of the State. Cities whose police officers or firefighters are appointed under the civil service law of the State are generally required to participate in the System. There are approximately 51y active members of the System. Membership in the System is required as a condition of employment.

The System established the Plan to provide its members with the opportunity to contribute amounts from current compensation to a tax-exempt trust for the purpose of funding certain post-retirement welfare benefits for members, their dependents, and designated beneficiaries. The Plan is recognized by the Internal Revenue Service as a voluntary employees' beneficiary association described in section 501(c)(9) of the Code. The System is the Plan Administrator and the Board is the Plan Trustee.

Membership in the Plan is voluntary. Active members of the System are eligible to participate in the Plan, which is funded solely by means of payroll deductions. No employer arranges for the payment of the cost of any life insurance offered through the Plan. Payroll

deduction contributions are to be made in units of $2y per quarter at the election of the member. Benefits are to be provided by the Plan generally for the period beginning when the employee retires at age 55 or later until the employee reaches the age of 65. The benefits may consist of a stream of monthly payments for the purpose of reimbursing the participant for health or life insurance premiums or, if the participant elects to receive health protection benefits as non-periodic benefits, the participant will be reimbursed for certain qualifying medical expenses, term life insurance premiums, or long-term care insurance premiums.

Rulings Requested:

You have requested the following rulings:

1. The Plan is not required to file an annual report on IRS Form 5500.

2. No account limit will apply to the Plan under section 419A of the Code, pursuant to section 419A(f)(5), since it is an employee pay-all plan that is expected to have more than 50 employee-members, and no member is entitled to a refund with respect to amounts in the fund.

3. None of the Plan's assets will fail to be "exempt function" income as amounts set aside to provide for the payment of life, sick, accident, or other benefits in excess of the above-referenced account limit under section 512(a)(3)(B) or (E) of the Code, and, therefore, the Plan will have no unrelated business taxable income under section 512.

4. Plan participants will not be entitled to a current deduction for contributions to the Plan.

Issue #1: Whether the Plan is required to file an annual report on IRS Form 5500, Annual Report of Employee Benefit Plan. This requires a determination that the Plan is a governmental plan as defined in section 414(d).

The Statute generally requires each city in which the fire fighters or police officers are appointed under the civil service law of the State to participate in the retirement system established by the Statute. The purpose of the retirement system is to provide retirement allowances for the fire fighters and police officers of those cities, or benefits to their dependents. The Statute vests the Board with general responsibility for the establishment and proper operation of the retirement system.

The Statute allows the Board to establish and administer voluntary benefit programs which include retiree health benefits, long-term care, and life insurance. According to the Statute, participation in the voluntary benefit programs must be voluntary and contributions to the voluntary benefit programs must be paid entirely by each participating member by means of payroll deduction. Cities that employ members participating in voluntary benefit programs are required to forward the amounts deducted to the Board for deposit in the voluntary benefit fund.

The Statute requires the Board to annually establish an investment policy to govern the

investment of the assets of the voluntary benefit fund. The Board must include in its annual budget the amount necessary to cover the operating expenses of the voluntary benefit programs. The Statute requires operating expenses to be paid from the voluntary benefit fund under the direction of the Board.

The Statute calls for a Board of thirteen members, including nine voting members and four nonvoting members. The voting members include fire fighters, police officers, and officials from participating cities, and a citizen who does not hold public office. The nonvoting members of the Board are state representatives and senators.

Law:

The current instructions to Form 5500 provide that employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) must file a Form 5500 annually. However, the instructions except governmental plans from this requirement.

Section 414(d) of the Code defines the term "governmental plan" to mean a plan established and maintained for its employees by the government of the United States, by the government of any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

Rev. Rul. 89-49, 1989-1 C.B. 117, provides that a plan will not be considered a governmental plan merely because the sponsoring organization has a relationship with a governmental unit or some quasi-governmental power. One of the most important factors to be considered in determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision is the degree of control that the federal or state government has over the organization's everyday operations. Other factors include:

1. Whether there is specific legislation creating the organization;
2. The source of funds for the organization;
3. The manner in which the organization's trustees or operating board are selected; and
4. Whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit.

Analysis:

With respect to the first factor of Rev. Rul. 89-49, the Statute establishes the Plan for the benefit of members of the System. The Statute provides that each city in which the fire fighters or police officers are appointed under the civil service law of the State shall participate in the System. Thus, there is specific legislation creating the Plan and specifically identifying it as an instrumentality of the State.

With respect to the second factor of Rev. Rul. 89-49, the Statute provides that contributions to the Plan shall be paid entirely by each participating member by means of payroll deduction. Cities employing members participating in the Plan shall forward the amounts

deducted to the Board for deposit in the Plan. Therefore, the Plan receives funding from employee-members and not from the State or its political subdivisions.

With respect to the third factor of Rev. Rul. 89-49, the Statute provides that the Board shall consist of fire fighters, police officers, city officials, a citizen who does not hold public office, and state representatives and senators. The Statute provides that the Board shall be responsible for contributions made under the Plan, shall be responsible for the general administration of the Plan, shall annually establish an investment policy to govern the investment and reinvestment of the assets in the Plan, shall include in its annual budget the amount of money necessary during the following year to provide for the expense of operation of the voluntary benefit programs, and shall direct the payment of the expenses of the Plan.

With respect to the fourth factor of Rev. Rul. 89-49, the System employees are employed by cities that are political subdivisions of the State. A participating city that has elected to participate in the Plan and whose employees make contributions to the Plan is considered to be the direct employer of a System employee.

Conclusion:

Except for the second factor of Rev. Rul. 89-49, the Plan has substantial characteristics of a governmental plan. On balance, we conclude that the Plan is a governmental plan for purposes of section 414(d) of the Code and, therefore, is not required to file an annual report on Form 5500.

Issue #2. Whether an account limit applies to the Plan under section 419A of the Code.

Law:

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 such account exceeding the account limits. Section 419A(a) of the Code defines a "qualified asset account" as 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(c) of the Code defines "account limit" as the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of such taxable year) for benefits referred to in subsection (a), and administrative costs with respect to such claims.

Section 419A(f)(5) of the Code provides that no account limits apply to accounts under a welfare benefit fund for an employee pay-all VEBA provided that (i) such plan has at least 50 employees and (ii) no employee is entitled to a refund with respect to amounts in the fund, other than experience refunds based on the experience of the entire fund.

Analysis:

The Plan is not yet in operation, since implementation is conditioned on the receipt of a favorable ruling. Therefore it is not possible to determine with any degree of certainty the number of members who will elect to participate in the Plan. There are approximately 51y active members of the System, all of whom will be eligible to participate in the Plan. Although total participation is expected to be in excess of 50 members, we are including a caveat that the Plan must maintain 50 or more participants at all times for section 419A(f)(5) of the Code to apply.

As provided by the Plan, no participant is entitled to a refund with respect to amounts in the fund, other than a refund based on the experience of the entire fund. Therefore section 419A(f)(5)(B)(ii) of the Code is satisfied.

Conclusion:

In view of the foregoing, we conclude that the Plan is excepted under section 419A(f)(5) of the Code from the account limits imposed under section 419A(b) as long as it maintains 50 participants in the Plan at all times.

Issue #3. Whether Plan assets are "exempt function income" under section 512(a)(3) of the Code.

Law:

Section 511 of the Code imposes a tax for each taxable year on the unrelated business taxable income of organizations described in section 501(c), including that of voluntary employees' beneficiary associations described in section 501(c)(9).

Section 512(a)(3)(A) of the Code provides that, in the case of an organization described in section 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less certain deductions which are directly connected with the production of the gross income, and taking into consideration certain modifications.

Section 512(a)(3)(B) of the Code provides that the term "exempt function income" means, in the case of an organization described in section 501(c)(9), all income (other than an amount equal to the gross income derived from any unrelated trade or business carried on by such organization) which is set aside to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with such purpose.

Section 512(a)(3)(E) of the Code provides that, in the case of any organization described in section 501(c)(9), a set-aside to provide for the payment of life, sick, accident, or other benefits, may be taken into account under section 512(a)(3)(B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under section 419A for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

Analysis:

Generally, an organization exempt under section 501(c)(9) of the Code is subject to unrelated business income tax on its gross income with the exception of any exempt function income. Exempt function income is, generally, income set aside to provide for the payment of life, sick accident, or other benefits, to the extent that the amounts set aside do not exceed the account limit for qualified asset accounts described in section 419(A). However, an employee pay-all plan with at least fifty employees in not subject to the account limit of section 419(A) so long as no employee is entitled to a refund other than a refund based on the experience of the entire fund.

With respect to issue 2, we concluded that the Plan is excepted from the account limits described in section 419A(b) of the Code because it is an employee pay-all plan described in section 419A(f)(5)(B) so long as it maintains at least fifty participants at all times.

Conclusion:

Consequently, as long as the Plan is an employee pay-all plan that meets the requirements of section 419A(f)(5)(B) of the Code, all income, other than gross income derived as a result of unrelated trade or business regularly carried on by the Plan (computed as if the Plan were subject to section 512(a)(1)), which is set aside to provide for the payment of life sick, accident, or other benefits, including reasonable costs of administration directly connected with such purpose, would be "exempt function income" for purposes of section 512(a)(3).

Issue #4. Whether Plan participants are entitled to a current deduction for contributions to the Plan.

Law:

Section 213 of the Code allows a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, taxpayer's spouse, or a dependent, to the extent that such expenses exceed 7.5 percent of adjusted gross income.

Section 213(d)(1) of the Code provides that the term "medical care" includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, and includes insurance covering medical care.

Section 213(d)(6) of the Code provides that, in the case of an insurance contract under which amounts are payable for other than medical care, no amount shall be treated as paid for insurance unless the charge for such insurance is either separately stated in the contract or furnished to the policyholder by the insurance company in a separate statement, the amount taken into account as the amount paid for such insurance shall not exceed such charge, and the charge for such insurance may not be unreasonably large in relation to the total charges under

the contract.

Section 1.213-1(e)(4) of the Income Tax Regulations states that, in the case of an insurance contract under which amounts are payable for other than medical care (as, for example, a policy providing an indemnity for loss of income or for loss of life, limb, or sight), (1) no amount shall be treated as paid for insurance covering expenses of medical care unless the charge for the insurance is separately stated in the contract or furnished to the policyholder by the insurer in a separate statement, (2) the amount taken into account as paid for such medical insurance shall not exceed such charge, and (3) no amount shall be treated as paid for such medical insurance if the amount specified in the contract (or furnished to the policyholder by the insurer in a separate statement) as the charge for such insurance is unreasonably large in relation to the total charges under the contract.

In Rev. Rul. 75-302, 1975-2 C.B. 86, Rev. Rul. 75-303, 1975-2 C.B. 87, and Rev. Rul. 76-481, 1976-2 C.B. 82, taxpayers were allowed a current deduction of payments for future medical care extending substantially beyond the close of the taxable year in situations where the future care was purchased in connection with obtaining lifetime care for specified residential accommodations, meals, and medical care.

Rev. Rul. 93-72, 1993-2 C.B. 77, states that Rev. Rul. 75-302, Rev. Rul. 75-303, and Rev. Rul. 76-481 should not be interpreted to allow a current deduction of payments for future medical care (including medical insurance) extending substantially beyond the close of the taxable year in situations where the future care is not purchased in connection with obtaining lifetime care of the type described in those rulings. *See also* Rose v. Comm'r, 52 T.C. 521 (1969).

Analysis and Conclusion:

As the payments in this case are paid by the participant by means of payroll deduction prior to a participant's retirement, and benefits are paid during the period after the participant's retirement at or after age 55, through age 65, the payments are not currently deductible at the time of payment. However, when participants become eligible for benefits, generally at age 55, payments allocable to each such year in which benefits are provided are deductible under section 213, subject to the limits described above, i.e., to the extent the requirements of section 1.213-1(e)(4) are satisfied and to the extent that the 7.5 percent floor is satisfied in any year.

Conclusion:

Accordingly, based solely on the facts submitted, we rule that:

1. The Plan is not required to file an annual report on IRS Form 5500.

2. The Plan is excepted under section 419A(f)(5) of the Code from the account limits imposed under section 419A(b) as long as it maintains 50 participants in the Plan at all times.

3. As long as the Plan meets the requirements of section 419A(f)(5)(B) of the Code, all income, other than gross income derived as a result of unrelated trade or business regularly carried on by the Plan (computed as if the Plan were subject to section 512(a)(1)), that is set aside to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with such purpose, would be "exempt function income" for purposes of section 512(a)(3) of the Code.

4. Participant payments are not currently deductible under section 213 of the Code at the time of payment.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose.* A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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 by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Michael Seto
Manager, Exempt Organizations
Technical Guidance & QA Group 1

Enclosure
Notice 437