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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
TEGE:EO2
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Date:
May 29, 2008

LEGEND
Trust =

Commission =

City =

Plan =

State =

Dear :

This is in reply to your letter dated December 14, 2007, requesting a ruling that the income of Trust is excluded from gross income under section 115(1) of the Internal Revenue Code.

FACTS

Trust is a common law trust formed by Commission. Commission is a department of City. It maintains and operates City's water utility and electric utility. In accordance with the City Charter, Commission is governed by a five member board of commissioners elected by the citizens of City. Commissioners serve without pay. Their term of office and election are prescribed by the city council by ordinance. Commission has contracted to provide various post-employment health and welfare benefits to its retired employees, their spouses and dependents pursuant to Plan.

Plan provides only insured health benefits. There are no self-insured benefits or reimbursement accounts. Commission's liability for the cost of benefits does not include the full cost of Plans' benefits. Generally, retirees and beneficiaries must pay a portion or all of their benefit costs. Both eligibility and cost of benefits vary based on retirement date, on whether the retiree or beneficiary is Medicare-eligible, and whether the individual is a retiree, spouse, child, surviving spouse or child or divorced spouse.

Commission represents that there is no cash-out of any amounts paid for Plan benefits and no conversion of sick or vacation days to post-retirement medical benefits. Commission also represents that Plans do not permit any benefits to be paid by pre-tax salary reduction.

Domestic Partners may be beneficiaries under Plan. Commission represents that, in administering Plan, Commission will make reasonable efforts to identify individuals who do not qualify as a spouse or as dependents (under section 152 of the Code) of retirees who participate in Plan and will, in accordance with applicable tax law, include in the income of retirees the value of Commission's portion of coverage for such individuals.

Commission established Trust to fund Commission's portion of the overall costs and to manage the provision of benefits. Trust is governed by a board of trustees. Under the Trust Agreement there must be at least five voting trustees. The trustees are selected by Commission. The Trust Agreement does not provide a set term for the trustees. Commission proposes to amend the Trust Agreement to clarify that a trustee can be removed and replaced by Commission at any time with or without cause. Pursuant to the Trust Agreement the trustees may direct the investment of trust assets themselves or they may appoint one or more asset managers and other professional service providers to administer the trust assets. Commission is the sole participating employer in Trust. Commission proposes to amend the trust agreement to provide that another entity may become participating employer in Trust only if it is a state, a political subdivision of state or an entity the income of which is excluded from gross income under section 115 of the Code.

Trust's income is derived from contributions made by Commission and investment income. Trust's income is used solely for retiree benefits and trust expenses. The Trust Agreement can be amended by the trustees with the consent of Commission. Upon termination, all of Trust's assets will be distributed in accordance with the Trust Agreement and Plan. Commission proposes to amend the Trust Agreement to provide that in no case will any remaining assets be distributed to an entity other than a political subdivision of a state or an entity the income of which is excluded from gross income under section 115 of the Code.

LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides health benefits to retired employees of Commission. Commission is a part of City, which is a political subdivision of State. Providing health benefits to current and former employees of such government entities constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of § 115(1) of the Code.

The income of Trust accrues to Commission, its sole participating employer. Commission is a part of City which is a political subdivision of State. No private interests participate in or benefit from the operation of Trust. Any distribution of remaining funds in Trust to participating retirees upon the dissolution of Trust satisfies an obligation the participating employer has assumed with respect to providing health benefits to its employees. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

Based on the information and representations submitted by Trust and providing the amendments described above are adopted, we hold that the income of Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1) as of the date the proposed amendments become effective. Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

No opinion is expressed concerning the federal tax consequences of the Trust under any other provision of the Code other than those cited above. In particular, no representation is made regarding the federal tax consequences of contributions to or payments from an employer's health plan(s), including (but not limited to) whether contributions to the plan(s) are excludable from the gross income of employees, former employees or retirees under section 106 and whether payments from the plan(s) (including reimbursements of medical expenses) are excludable from the gross income of employees, former employees or retirees under sections 104 or 105.

The participating employers are responsible for determining the tax status of all disbursements made to or on behalf of eligible recipients. The participating employers are also responsible for performing any tax reporting obligations resulting from any such disbursements.

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

Sincerely,

Sylvia F. Hunt
Assistant Chief, Exempt Organizations
Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:
Copy of this letter
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CC: