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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number

UIL: 111.00-00; 419.00-00; 501.00-00
501.09-00; 501.09-01

SE:T:EO:RA:T:2

Legend

M =
N =
O =
Date =
Date2 =

Dear :

This is in reply to your letter, dated December 27, 2004, requesting a ruling on a proposed transaction involving a trust, M, that is a tax-exempt voluntary employees' beneficiary association (VEBA) under section 501(c)(9) of the Internal Revenue Code (Code). You, the employer, N, propose to transfer assets held in M's retired lives reserve that are attributable to contributions made prior to the effective date of DEFRA, to a post-retirement health account within M to pay post-retirement health benefits.

M seeks the following rulings:

1. The proposed transaction will not adversely affect its tax-exempt status under section 501(c)(9) of the Internal Revenue Code (Code).

2. The proposed transaction will not cause N to include any amount in gross income under section 61.

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

4. N will not recognize unrelated business taxable income solely as a result of the proposed transaction.

Facts:

M is a VEBA that is exempt from federal income tax under section 501(c)(9) of the Code. N currently provides post-retirement life insurance benefits to its eligible retired employees through M. The purpose of M is to provide retiree life insurance and other post-retirement benefits. However, to date, only life insurance benefits have been provided.

M is a successor to a VEBA maintained by O, its former parent corporation that provided post-retirement life insurance benefits to its eligible retired employees. N was spun off from O in Date, and M was created by transferring assets from O's VEBA. The amount of assets transferred to M was proportionate to the post-retirement life insurance benefit obligation of employees transferred to N at the time of the spin-off from O.

N proposes to transfer assets held in M's retired lives reserve that are attributable to contributions prior to the effective date of the Deficit Reduction Act of 1984 (DEFRA), to a post-retirement health account within M to pay post-retirement health benefits.

All of the contributions in O's VEBA that were made prior to the effective date of DEFRA were deducted under section 162 of the Code. The portion of M's retired lives reserve that is attributable to O's contributions made prior to the effective date of DEFRA constitute M's Pre-DEFRA Reserve. N did not make any contributions to M, or take any deductions for contributions made to M. Thus, all of the assets in M are attributable to contributions made by O's VEBA to M.

M's Pre-DEFRA reserve has been determined in accordance with the methodology set forth in section 1.512(a)-5T, Q&A-4 of the regulations. However, in applying this methodology, the term "Pre-DEFRA Reserve" was substituted for the regulations' "existing reserve for post-retirement medical or life insurance benefits," and the date "December 31, 1985" (i.e., the date after which section 419 became effective) was substituted for the date "July 18, 1984" appearing in those regulations. Furthermore, N assumed that the asset transfer from O's VEBA to M included a ratable portion of the transferor's Pre-DEFRA reserve. M's Pre-DEFRA reserve as of Date2 was $. The total retired lives reserve as of Date2 was $.

At present, no retired lives reserve assets may be used for purposes other than providing life insurance so long as any current covered employee remains alive. N proposes to amend the trust agreement to provide that the Pre-DEFRA Reserve held in the retired lives reserve may be used to provide post-retirement health benefits for N's retirees. N plans to establish a separate health account within M. N will determine the amount of the Pre-DEFRA Reserve that may potentially be transferred from the retired lives reserve in any taxable year of N, on any day during such year that is on or before the transfer date. An amount of Pre-DEFRA Reserve, as determined by N, will be transferred from the retired lives reserve to the health account within M. If N elects not to transfer any of the Pre-DEFRA Reserve to the health account during a particular taxable year, then the applicable retired lives reserve assets will be used to provide only post-retirement life insurance benefits during the year.

M will provide that no amounts other than a Pre-DEFRA Reserve will be transferred to the health account for the purpose of providing post-retirement health benefits. No funds will be transferred from the retired lives reserve to provide post-retirement health benefits unless the amount of the Pre-DEFRA Reserve is at least as great as the amount to be released. Only an amount that N reasonably determines would otherwise be currently deductible under section 419A(c)(2) of the Code as a contribution to fund post-retirement health benefits may be transferred in any taxable year to provide post-retirement health benefits. If funds and earnings thereon in the health account have not been exhausted by the end of any taxable year of N, then the remaining funds and earnings thereon will remain in the health account and will continue to be available to fund post-retirement health benefits in future years.

M will only receive future contributions from N to the extent that such contributions do not exceed the amount permitted under section 419A to fund post-retirement life insurance benefits. This amount will be the sum of:

1. amounts reasonably and actuarially necessary to fund claims incurred but unpaid for post-retirement life insurance for the covered retiree population;

2. administrative costs with respect to such claims; and

3. contributions reasonably and actuarially necessary to fund a reserve that provides post-retirement life insurance benefits for the current retirees, and the employees who may become retirees, covered by M and that is actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) over the working lives of such individuals.

N represents that it will not have the right to receive the assets of M or the retired lives reserve at any time.

Law:

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means 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.

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 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 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).

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 a welfare benefit fund were controlled by section 162.

Section 419 of the Code states that an employer's contributions to a welfare benefit fund are deductible only if they would otherwise be deductible under Chapter 1 of the Code, and the amount of the deduction is limited to the welfare benefit fund's qualified cost for the taxable year. One component of qualified cost is a fund's qualified direct cost for the year, which is the amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the year if those benefits had been provided directly by the employer, and the employer had used the cash receipts and disbursements method of accounting. A second component of qualified cost is any addition to a qualified asset account for the taxable year, but only to the extent the addition does not exceed specified limits. Further, the qualified cost for the taxable year is reduced by the fund's after-tax income for the year.

Section 419A(a) of the Code states that the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment benefits or severance pay benefits, or life insurance benefits.

Sections 419A(b) and 419A(c)(1) of the Code generally limit the additions to a qualified asset account to an amount that is reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for the benefits referred to above, plus administrative costs with respect to those claims.

Section 419A(c)(2) of the Code states that the account limit for any year may also include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary for (A) post-retirement medical benefits to be provided to covered employees or (B) post-retirement life insurance benefits to be provided to covered employees.

Section 501(c)(9) of the Code describes a voluntary employees' beneficiary association providing for the payment of life, sick, accident or other benefits to its members or their dependents or designated beneficiaries, and in which no part of its net earnings inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 4976(a) of the Code imposes an excise tax in the amount of 100 percent of the amount of any disqualified benefit provided by a welfare benefit fund. Under section 4976(b)(1)(C), the term "disqualified benefit" includes any reversion to the employer of any part of a welfare benefit fund.

Section 4976(b)(3) of the Code provides that paragraph (b)(1)(C) of section 4976 does 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 taxable year.

Section 1.162-10 of the Treasury Regulations, in effect prior to the effective date of sections 419 and 419A, 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.

Section 1.501(c)(9)-3(c) of the regulations provides the payment of medical insurance premiums for active employees is a permissible benefit.

Section 1.501(c)(9)-4(a) of the regulations provides that no part of the net earnings of an employee's association may inure to the benefit of any shareholder or individual other than through the payment of permissible benefits. Whether prohibited inurement has occurred is a question to be determined with regard to all the facts and circumstances of a particular case.

Section 1.512(a)-5T, Q&A-4(a) of the regulations states that an "existing reserve for post-retirement medical or life insurance benefits" (as defined in section 512(a)(3)(E)(iii)(II)) is the total amount of assets actually set aside in a VEBA on July 18, 1984 (calculated in the manner set forth in Q&A-3 of the regulation, and adjusted under paragraph (c) of Q&A-11 of section 1.419-1T), reduced by employer contributions to the fund on or before such date to the extent such contributions are not deductible for the taxable year of the employer containing July 18, 1984, and for any prior taxable year of the employer, for purposes of providing such post-retirement benefits.

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 stated 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 the 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.

<u>Analysis</u>:

Section 501(c)(9)

With respect to Ruling Request #1, <u>N</u> represents that <u>M</u> will continue to provide permissible benefits, i.e., the payment of postretirement life insurance premiums as well as health benefits for active and retired employees. Accordingly, the transfer of assets to <u>M</u> and the proposed use of <u>M</u> assets will not result in prohibited inurement or otherwise affect the exempt status of <u>M</u> under section 501(c)(9).

Tax Benefit Rule

With respect to Ruling Request #2, 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." <u>Hillsboro National Bank</u>, 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.

For the deduction taken under section 162 of the Code for a contribution to a welfare benefit fund prior to the applicability of section 419, no distinction was made between the types of post-retirement welfare benefits provided through the fund. Thus, the original deductions would not have been foreclosed merely because the reserve amounts could be used for post-retirement health benefits as proposed. However, the deduction for those post-retirement 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.

N has represented that all of the contributions to the retired lives reserve would have been fully deductible under section 162 if the contributions had in fact been made to provide post-retirement health benefits.

Based on N's representation, as described in the preceding paragraph, that all of the contributions to the retired lives reserve would have been fully deductible under section 162 if the contributions to the retired lives reserve had in fact been made to provide post-retirement health benefits, 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, transferring funds from the retired lives reserve attributable to Pre-DEFRA amounts that were originally contributed to fund post-retirement life insurance, in order to now fund post-retirement 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.

Section 4976

With respect to Ruling Request #3, N represents that the Pre-DEFRA reserve is solely attributable to contributions paid or accrued prior to January 1, 1986 (the effective date of section 419). Thus, section 4976(b)(1)(C) does not apply with respect to the amounts proposed to be transferred from the Pre-DEFRA reserve to the health account, because those amounts are attributable to contributions to M which were not "allowable as a deduction under section 419 for the taxable year or any prior taxable year" within the meaning of section 4976(b)(3). Accordingly, the proposed transfers will not result in the provision of a "disqualified benefit" within the meaning of section 4976 and, consequently, will not cause N to be liable for the tax imposed by section 4976.

Unrelated Business Income

With respect to Ruling Request #4, N represents that the assets in M will consist solely of an existing reserve for postretirement health or life insurance benefits within the meaning of section 512(a)(3)(E)(ii). Accordingly, M will not recognize unrelated business taxable income solely as a result of the transfer of assets from the retired lives reserve to pay postretirement health benefits.

Based on the foregoing, we rule, as requested, as follows:

1. The proposed transaction will not adversely affect M's tax-exempt status under Section 501(c)(9) of the Code.

2. The proposed transaction will not cause N to recognize taxable income under the tax benefit rule.

3. The proposed transaction will not cause N to incur excise tax under section 4976.

4. The proposed transaction will not cause M to recognize unrelated business taxable income.

This ruling is directed only to the taxpayer who requested it. Section 6110(j) 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. This ruling is based on the understanding there will be no material changes in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service.

Please keep a copy of this ruling in your organization's permanent records.

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.

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,

Ronald Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure: Notice 437