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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.
Telephone Number:

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PLR-137209-09
Date:
November 05, 2009

LEGEND:

Taxpayer =

State =

Trust =

Plan =

Dear :

This is in reply to your letter dated August 11, 2009, in which you request various rulings on behalf of Taxpayer with respect to Plan and Trust.

Taxpayer, a political subdivision of State, adopted Plan as a means of providing health insurance and prescription drug benefits for its retirees, the survivors and eligible dependents of retirees, and retirees of certain other government agencies. Under Plan, Taxpayer provides post-retirement health insurance coverage for retirees of Taxpayer who have satisfied certain age, service, and other requirements. Taxpayer pays a portion of the premium for health insurance coverage for eligible retirees. Participants are responsible for the remainder of the premium.

Taxpayer represents that there are no pre-tax salary reduction elections under the Plan.

In addition, Taxpayer represents that Plan does not permit a cash-out of unused amounts or a conversion of sick or vacation days to retiree health benefits. Participants may not salary-reduce to pay for any benefit.

Taxpayer does not currently provide benefits to individuals who do not qualify as a spouse or as a dependent under § 152 of the Internal Revenue Code (the Code). However, if Taxpayer extends benefits to a non-spouse or non-dependent, Taxpayer will take reasonable steps to identify individuals who do not qualify as a spouse or dependent and, in accordance with applicable tax law, include in the income of related employees the fair market value of the coverage relating to any such individual's participation in Plan.

Taxpayer created Trust to provide a reserve to pay health benefits for its retirees, their spouses and dependents, and surviving spouses and dependents. Trust's income is derived from Taxpayer contributions and investment income. Employees and retirees are not permitted to contribute to Trust. The funds in Trust can only be used for health benefits for retirees in accordance with Plan, administration costs and the accumulation of a reserve to fund Taxpayer's share of the cost of Plan. No part of Trust's net earnings inure to the benefit of any private person. Private interests do not participate in or benefit from the income of Trust.

Investment authority over Trust is vested in its trustees. The original trustees are employees of Taxpayer. Trust may be amended or terminated by Taxpayer at any time for any reason. Upon termination of Trust, assets of Trust will be transferred to one or more trust funds provided such trust funds are for the purpose of providing health benefits under Plan. In the event Taxpayer no longer has a liability for providing health benefits to participants in Plan, any remaining trust assets will be transferred to Taxpayer. In no event will the assets be transferred to an entity that is not a state, a political subdivision of state or an entity the income of which is excluded from taxation under §115 of the Code.

LAW & 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 § 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 Taxpayer, a political subdivision of State. Providing health benefits to current and former employees of a political subdivision 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 Taxpayer and certain other government agencies. Upon the dissolution of Trust, the use of its remaining fund to provide health benefits to retirees satisfies an obligation the participating employers have assumed with respect to providing health benefits to their employees. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

Section 301.7701-1(b) of the Procedure and Administration Regulations provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides for special treatment of that organization.

Section 301.7701-4(a) provides that, in general, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. If an entity has both associates and a business purpose, it cannot be classified as a trust for federal income tax purposes.

Section 6012(a)(4) of the Code provides that every trust having for the taxable year any taxable income or having gross income of $600 or over, regardless of the amount of taxable income, shall make a return with respect to income taxes under subtitle A.

Section 61(a)(1) of the Code and § 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A of the Code, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106(a) of the Code provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1(a) of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in § 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in § 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, § 106 applies only to the portion of the contributions allocable to accident or health benefits.

Coverage provided under an accident and health plan to former employees and their spouses and dependents is excludable from gross income under § 106. See Rev. Rul. 62-199, 1962-2 C.B. 38; Rev. Rul. 82-196, 1982-2 C.B. 53.

Section 105(a) provides that, except as otherwise provided in § 105, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 105(b) provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in § 213)) of the taxpayer, his spouse, and his dependents (as defined in § 152 of the Code).

Based on the information submitted and representations made by Taxpayer, we conclude as follows:

(1) 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). Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

(2) Trust is classified as a trust for federal income tax purposes under § 301.7701-4(a). No annual income tax return is required to be filed by Trust pursuant to § 6012(a)(4).

(3) Contributions paid to Plan and payments made from Plan which are used exclusively to pay for the accident or health coverage of retired employees and their spouses and dependents (as defined in § 152 of the Code) are excludable from the gross income of retired employees and retired employees' spouses and dependents under §§ 106 and 105(b) of the Code.

No opinion is expressed concerning the Federal tax consequences of Plan or Trust under any other provision of the Code other than those specifically stated herein. In particular, § 3.01(9) of Rev. Proc. 2009-3, 2009-1 I.R.B.107 provides that the Service will not issue a ruling concerning whether a self-insured medical reimbursement plan satisfies the requirements of § 105(h) for a plan year. Accordingly, no opinion is expressed concerning whether Plan, if it provides self-insured benefits, satisfies the nondiscrimination requirements of §105(h) of the Code and § 1.105-11 of the regulations.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Harry Beker, Chief
Health and Welfare Branch
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)