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Legend

School Board =

District =

State =

Medical Plan =

Dental Plan =

Trust =

Dear :

FACTS

School Board is a political subdivision of State that operates and manages District's public school system. State's Constitution enables the legislature to create district school boards and under State's Revised Statutes, district school boards are established as "bodies corporate." School Board administers and oversees the operations of public schools in District which includes the determination as to the number of schools to be opened and operated, the hiring and termination of administrative personnel and teachers (and fixing of salaries), the budgeting of the use of tax funds to defray the cost of operating schools and the establishment of all policies with regard to the operation of public schools.

School Board has adopted Medical Plan and Dental Plan (Plans) which are offered to its current employees and its retired employees. School Board is the sole employer participating in Plans. School Board pays 85% of the medical and dental insurance premiums for retired employees who are responsible for the remainder. There are no pre-tax salary-reduction elections under the plans. Participants may not salary reduce to pay for any benefit. Neither Plan permits a cash-out of unused amounts or conversion of unused sick leave or vacation days to retiree health benefits. School Board currently provides benefits only for individuals who qualify as a spouse or eligible dependent under §152 of the Internal Revenue Code (the Code).

School Board established Trust to currently fund retiree health benefits. Trust was created and funded by School Board solely for the benefit of retirees and their eligible spouses and dependents. The parties to the trust agreement are School Board and the trustee of Trust. Upon termination of Trust or either of the Plans offered by School Board, Trust funds shall be returned to School Board. Trust assets are free from claims of creditors to fullest extent allowable under State law. In no event will Trust assets be transferred to an entity which is not a state, a political subdivision or an entity whose income is excluded from gross income under section 115. Trust assets are to be used exclusively to pay for benefits provided by the plans and for the administration of Trust. Private interests do not participate in the Trust and no part of Trust's property may be diverted to purposes other than the exclusive benefit of the retirees and their eligible spouses and dependents.

School Board has exclusive authority and discretion to manage and control the assets of the Trust, but will delegate investment management of Trust's assets to the trustee pursuant to the terms of the trust agreement. School Board represents that the purpose of Trust is to vest in the trustee responsibility for the protection and conservation of Trust property for the benefit of Plan participants, their spouses and dependents, none of whom can share in the discharge of this responsibility for profit.

The members of Trust's Board of Trustees include the District Superintendent of Schools, the Director of Budget Services and the three members of the School Board's Budget and Finance Committee. The Superintendent and Director of Business Services are appointed by School Board. The Board of Trustees meets annually and makes decisions by majority vote. The Board of Trustees may take no action which jeopardizes the exclusion of Trust's income from gross income under section 115(1) of the Code, and no part of the Trust's net earnings can inure to the benefit of a member of the Board of Trustees. The members of the Board of Trustees shall not engage in any acts of self-dealing and shall consistently maintain their fiduciary status with the Trust and its beneficiaries.

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 utility 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.

School Board is a political subdivision of State that is enabled by State's Constitution and established pursuant to statute to carry out the essential government function of public education including the budgeting of the use of tax funds to defray the cost of operating schools and establishment of all policies with regard of operation of public schools. School Board offers medical and dental coverage to its retired employees. Providing health benefits to current and former employees constitutes the performance of an essential government function. Trust was established by School Board to help fund the benefits offered its retired employees. 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.

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.

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.

However, 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. 32; 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 medical care (as defined in § 213(d)).

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) of the Procedure and Administration Regulations 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.

Section 6012(a)(4) 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.

Based on the information submitted and representations made, 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 within the meaning of §7701(a) of the Code and § 301.7701-4(a) of the regulations. Trust is not required to file an annual income tax return under § 6012(a)(4) of the Code.

(3) Contributions paid to Trust and payments made from Trust pursuant to the Plans which are used to pay for the accident or health coverage of retired employees, 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 Trust or Plans under any other provision of the Code, other than those specifically stated herein. 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
Branch Chief, Health and Welfare Branch
Office of Division Counsel/Associate
Chief Counsel
(Tax Exempt & Government Entities)