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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **201442064**
Release Date: 10/17/2014

Date: July 21, 2014

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL: 419.00-00; 419A.00-00; 4976.00-00; 4976.01-00;
61.00-00

Legend:

Taxpayer =
Trust =
Company A =
Company B =
Company C =
Company D =
Plan A =
Plan B =
Union(s) =
Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =

Dear :

This responds to your letter dated December 30, 2011, requesting rulings regarding the tax consequences of a proposed transaction involving Trust. The assets in Trust are currently held to provide retiree life insurance benefits to Union-represented retirees of Taxpayer. The transaction addressed in this ruling would permit the assets in Trust also to be used to provide retiree health benefits to Union-represented retirees.

FACTS

Taxpayer is organized as a Delaware corporation and was formed through the merger of several companies. Taxpayer is the successor of Company A, Company B, and Company C.

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Taxpayer provides life, health, and other welfare benefits to active and retired employees (and their eligible spouses and dependents) through several welfare benefit plans, including Plan A and Plan B. Plan A provides group term life insurance, supplemental life insurance, and accidental death and dismemberment insurance to active employees, and also provides group term life insurance and supplemental life insurance to retired and disabled employees. The covered employees are, or were before their retirement, represented by Unions. Plan B provides retiree medical and dental benefits to certain retired employees who were, before their retirement, represented by Unions.

Trust assets have been used or held in a reserve to provide retiree life insurance benefits for Union-represented retirees under Plan A. No assets of Trust have been used to pay other benefits.

Taxpayer and its predecessors negotiated the benefits currently provided under Plans A and Plan B through arm's-length bargaining with Unions. The benefits for retired employees under these plans are provided under a series of collective bargaining agreements that were in effect when the covered individuals retired. The collective bargaining agreements satisfy the requirements of section 7701(a)(46).

Trust has received a determination letter indicating that it is a voluntary employees' beneficiary association under section 501(c)(9). The assets held in Trust were accumulated in retired lives reserves maintained as separate accounts under group-term life insurance policies issued to Company B's predecessor, Company D, and its affiliates. Effective Date 1, when Company D spun off Company B and the other companies, Company D allocated the policy reserves among the spun-off companies. Company B established separate retiree life insurance plans for management and non-management employees effective Date 2, and maintained the policies and retired lives reserves to provide life insurance benefits under the plans. Company B established Trust effective Date 3, and insurance policies and retired lives reserves attributable to Union-represented employees and retirees covered by Plan A were transferred to Trust. Trust was funded solely with the transferred retired lives reserves, and no contributions have been made to Trust since it was established.

Records maintained by Company B show that no contributions were made to the retired lives reserves after Year 1. However, Taxpayer has not been able to determine whether any contributions were made to the retired lives reserves from Year 2, when the reserves were transferred, through Year 1. Taxpayer believes that most of the assets in the retired lives reserves were attributable to the policy reserves accumulated before Year 2 and transferred to Company B by Company D. Taxpayer has assumed for purposes of this request that Trust might hold some assets attributable to contributions made after December 31, 1985, when the welfare benefit fund provisions of the Deficit Reduction Act of 1984 (DEFRA) became effective.

Taxpayer intends to create an umbrella welfare benefits plan that will provide medical, dental, vision, and life insurance benefits to certain active and retired Union-represented employees of Taxpayer through component plans. Plan A and Plan B will become component plans. Trust will be amended to permit the assets originally transferred from retired lives reserves under group insurance policies to be used to provide retiree health benefits to Union-represented retirees who are covered by Plan B. Assets from the existing retiree life insurance reserve would be transferred to a retiree health reserve in Trust, and the assets would be paid out from the retiree health reserve as needed to provide medical and dental benefits to Union-represented retirees who are covered by the Plan B component of the umbrella plan. Any assets remaining in the retiree life insurance reserve will continue to be used to provide retiree life insurance benefits for Union-represented retirees who are covered by the Plan A component of the umbrella plan.

Taxpayer represents that:

1. Most of the assets in Trust are derived from contributions originally accumulated in retired lives reserves before 1985 (Pre-DEFRA Contributions), though Company B may have made some contributions to the retired lives reserves after 1985 (Post-DEFRA Contributions).1

2. Trust is a separate welfare benefit fund that provides only retiree life insurance benefits pursuant to collective bargaining agreements as described in section 419A(f)(5). The retiree health reserve will be a separate welfare benefit fund under a collective bargaining agreement as described in section 419A(f)(5), and assets to be transferred to the retiree health reserve will provide retiree health benefits pursuant to collective bargaining agreements as described in section 419A(f)(5).

3. Pre-DEFRA Contributions were deducted when made under section 162, and would have been fully deductible under section 162 if the contributions had in fact been made to provide post-retirement health benefits.

4. Post-DEFRA Contributions would have been deducted pursuant to section 419A(f)(5)(A).

5. Under the terms of Trust and consistent with the prohibited inurement rules of section 501(c)(9),Taxpayer is prevented from recovering assets held in Trust.

REQUESTED RULINGS

Taxpayer has requested that the Service rule as follows:

1. The transfer of assets from the retiree life insurance reserve to the retiree health reserve in Trust will not cause Taxpayer to include any amount in gross income under section 61.

2. The use of transferred assets to provide medical and dental benefits to Union retirees covered by Plan B will not cause Taxpayer to include any amount in gross income under section 61.

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1 Sections 419(a) and 419A, which were enacted as part of the Deficit Reduction Act of 1984, are generally applicable to contributions paid or accrued after December 31, 1985, in taxable years ending after such date. For purposes of this ruling, contributions made to the retired lives reserves prior to January 1, 1986, are referred to as Pre-DEFRA Contributions, and contributions made to the retired lives reserves after December 31, 1985, are referred to as Post-DEFRA Contributions.

3. The transfer of assets from the retiree life insurance reserve to the retiree health reserve in Trust, and the use of the transferred assets to provide retiree health benefits, will not result in any "disqualified benefit" within the meaning of section 4976(b)(1)(C), and will not, in and of itself, cause Taxpayer to be liable for the excise tax imposed by section 4976.

LAW

Section 61(a) provides that, unless otherwise excepted, gross income includes all income from whatever source derived.

Section 111(a) 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 an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983); see also Hughes & Luce, LLP v. Commissioner, 70 F.3d 16 (5th Cir. 1995), cert. denied, 517 U.S. 1208 (1996). The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. Frederick v. Commissioner, 101 T.C. 35, 40-41 (1993). 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 partially codified at section 111(a) and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted; the exclusionary part cannot apply unless the inclusionary part applies.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro National Bank, 460 U.S. at 377. The general purpose of the tax benefit rule 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 a later event is "fundamentally inconsistent" with the premise on which the deduction was initially based, even in situations where 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).

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-10 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) if they are ordinary and necessary expenses of the trade or business.

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Section 1.162-10T, Q&A-2, provides that section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date.

Section 419(a) provides that contributions paid or accrued by an employer to a welfare benefit fund are not deductible under Chapter 1, but if they would otherwise be deductible, are (subject to the limitation of section 419(b)) deductible under section 419 for the taxable year in which paid.

Section 419(b) limits the employer's deduction under section 419(a) to a welfare benefit fund's qualified cost for the taxable year. The qualified cost of a welfare benefit fund for a taxable year is defined in section 419(c)(1) as the sum of the qualified direct cost for the taxable year and, subject to the limitation of section 419A(b), any addition to a qualified asset account for the taxable year. Under section 419(c)(2), the qualified cost for any taxable year is reduced by the welfare benefit fund's after-tax income for the taxable year.

Section 419(c)(3)(A) provides that the term "qualified direct cost" means, with respect to any taxable year, the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if those benefits were provided directly by the employer and the employer used the cash receipts and disbursements method of accounting.

Section 419(c)(3)(B) provides that, for purposes of section 419(c)(3)(A), a benefit is treated as provided when that benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for any provision of Chapter 1 of the Code excluding that benefit from gross income). Section 419A(a) defines the term "qualified asset account" to include any account consisting of assets set aside to provide for the payment of medical or life insurance benefits.

Section 419(e)(1) defines the term "welfare benefit fund" to include any fund through which the employer provides welfare benefits to employees or their beneficiaries. The term "fund" is defined in section 419(e)(3) to include an organization described in section 501(c)(9), and also, to the extent provided in regulations, any account held for an employer by any person.

Section 419A(b) provides that no addition to any qualified asset account may be taken into account under section 419(c)(1) to the extent such addition results in the amount of such account exceeding the account limit.

Section 419A(f)(5)(A) provides that no account limits shall apply in the case of a qualified asset account under a separate welfare benefit fund under a collective bargaining agreement.

Section1.419-1T, Q&A-2(a) of the regulations, provides that section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date.

Section 1.419-2T, Q&A-1 provides, in pertinent part, that neither contributions to nor reserves of a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until the earlier of : (i) The date upon which the last of the collective bargaining agreements relating to the fund in effect on the date of issuance of final regulations concerning such limits terminates, or (ii) the date three years after the issuance of final regulations.

Section 1.419A-2T, Q&A-2 states:

(1) For purposes of Q&A-1, a collectively bargained welfare benefit fund is a welfare benefit fund that is maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement and which meets the requirements of the Secretary of the Treasury as set forth in paragraph (2) below.

(2) Notwithstanding a determination by the Secretary of Labor that an agreement is a collective bargaining agreement, a welfare benefit fund is considered to be maintained pursuant to a collective bargaining agreement only if the benefits provided through the fund were the subject of arms-length negotiations between the employee representatives and one or more employers, and if such agreement between employee representatives and one or more employers satisfies Code section 7701(a)(46). Moreover, the circumstances surrounding a collective bargaining agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund. Finally, a welfare benefit fund is not considered to be maintained pursuant to a collective bargaining agreement unless at least 50 percent of the employees eligible to receive benefits under the fund are covered by the collective bargaining agreement.

(3) In the case of a collectively bargained welfare benefit fund, only the portion of the fund (as determined under allocation rules to be provided by the Commissioner) attributable to employees covered by a collective bargaining agreement, and from which benefits for such employees are provided, is considered to be maintained pursuant to a collective bargaining agreement.

(4) Notwithstanding the preceding paragraphs and pending the issuance of regulations setting account limits for collectively bargained welfare funds, a welfare benefit fund will not be treated as a collectively bargained welfare benefit fund for purposes of Q&A-1 if and when, after July 1, 1985, the number of employees who are not covered by a collective bargaining agreement and are eligible to receive benefits under the fund increases by reason of an amendment, merger, or other action of the employer or the fund. In addition, pending the issuance of such regulations, for purposes of applying the 50 percent test of paragraph (2) to a welfare benefit fund that is not in existence on July 1, 1985,

"90-percent" shall be substituted for "50-percent."

Section 4976(a) imposes a 100 percent excise tax if an employer maintains a welfare benefit fund and there is a disqualified benefit provided during any taxable year.

Section 4976(b)(1)(C) defines "disqualified benefit" to include any portion of a welfare benefit fund reverting to the benefit of the employer.

Section 4976(b)(3) provides that section 4976(b)(1)(C) does not apply to any amount attributable to a contribution to the fund that is not allowable as a deduction under section 419 for the taxable year or any prior taxable year.

In Revenue Ruling 73-599, 1973-2 C.B. 40, modified by Rev. Rul. 77-92, 1977-1 C.B. 41, the issue was whether the balance in a retired lives reserve had to be included in the gross income of the employer in the taxable year in which the employer terminated the insurance contract. The balance was attributable to premiums paid by the employer and interest increments added by the insurance company. At the time it terminated the insurance contract, the employer directed that the insurance carrier should transfer the balance in the retired lives reserve to a trust qualified as a VEBA under section 501(c)(9). The employer had deducted the premiums paid into a retired lives reserve during the years when it was maintaining the insurance contract for the benefit of its employees. The insurance contract provided that, upon cancellation or other termination of the contract, any balance in the retired lives reserve could be distributed to the employer as a dividend or, at the employer's option, transferred to a trust qualified under section 501(c)(9) for the purpose of providing insurance coverage for retired employees. Under these facts, the ruling holds that the balance in the retired lives reserve was includable in the employer's gross income under section 61(a) in the year of the transfer. The ruling states that, because the insurance contract gave the employer a fixed right to receive the balance in the retired lives reserve in the year in which it terminated its coverage under the policy, that balance was includable in the employer's gross income for the year of the termination, notwithstanding the fact that the employer directed the insurance company to transfer the money to a section 501(c)(9) trust. The ruling also holds that, in those cases in which the tax benefit rule under section 111 applies, the rule applies only to that part of the balance that was accumulated out of premiums; it does not apply to that part of the accumulated balance that is the interest increments.

Similarly, in Revenue Ruling 77-92, a corporate employer with a group term insurance program that included a retired lives reserve had the option to discontinue the insurance coverage and to direct the insurance carrier to use the amount in the retired lives reserve either to pay premiums for insurance on the lives of retired employees or to pay a dividend to the employer. The employer terminated the insurance contract and directed the insurance carrier to transfer the balance in the retired lives reserve to another insurance company to purchase insurance for retired employees. The ruling states that the facts presented are in substance the same as those contained in Rev. Rul. 73-599, except that the right reserved to the employer in Rev. Rul. 77-92 to transfer the funds remaining in the retired lives reserve consisted of the right to direct payment to those funds to another insurance company rather than to a trust that qualified for exemption under section 501(c)(9). However, this difference was not considered material because the taxpayer's right of control over the retired lives reserve was substantially the same in both cases. Accordingly, the ruling concludes that the same basic federal income tax rules apply to the transfers in the two cases. The ruling also states that the portion of the transferred reserve accumulated out of premiums paid or incurred in taxable years ending after June 17, 1969, is not includible in the employer's income because such premiums were not deducted since the employer retained the right of recapture.

ANALYSIS AND CONCLUSION

RULING REQUESTS 1 AND 2:

In this case, with regard to the transfer of assets from the existing retiree life insurance reserve to a retiree health reserve within Trust, Taxpayer represents that there are provisions prohibiting the reversion of any Trust assets to Taxpayer. The provisions precluding Taxpayer from receiving a reversion distinguishes this case from the situations considered in Rev. Ruls. 73-599 and 77-92. Therefore, because Taxpayer does not have any right to a reversion of the existing retiree life insurance reserve that will be transferred to a retiree health reserve within Trust, such transfer will not cause Taxpayer to realize income under section 61 with respect to the balance attributable to earnings on the retired lives reserve. Also, with respect to the balance attributable to contributions, Taxpayer will not have income from the transfer unless the inclusionary part of the tax benefit rule otherwise applies. As discussed below, the inclusionary part of the tax benefit rule will not apply with respect to contributions.

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." Hillsboro, 460 U.S. at 385.

The proposed transaction involves using assets attributable to both Pre-DEFRA and Post-DEFRA Contributions. Any deductions for Pre-DEFRA Contributions would have been taken by Company D under section 162, limited by the rules set out in Rev. Rul. 69-382, Rev. Rul. 69-478, and Rev. Rul. 73-599. For deductions taken under section 162 for a contribution to a welfare benefit fund, 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.

Taxpayer has represented that all of the Pre-DEFRA Contributions to the retired lives reserves would have been fully deductible under section 162 if the contributions had in fact been made to provide post-retirement health benefits. Based on Taxpayer's representation, the original deductions would not have been foreclosed had the proposed transaction occurred in the taxable year of the deductions. Moreover, this approach is consistent 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 Contributions that were originally made 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. Therefore, the inclusionary part of the tax benefit rule will not apply with respect to Pre-

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DEFRA Contributions.

Taxpayer has represented that Post-DEFRA Contributions would have been deducted pursuant to section 419A(f)(5)(A). In computing Taxpayer's deduction for contributions to the retired lives reserve, those contributions are not treated as exceeding the qualified cost limitation of section 419(b). As a result, if the proposed transaction had occurred within the same taxable year as the deduction, the deduction would not have been foreclosed. We conclude that the inclusionary part of the tax benefit rule will not apply with respect to any Post-DEFRA Contributions.

We conclude that the proposed transaction is not fundamentally inconsistent with the premise on which the deductions were based, and the tax benefit rule does not require Taxpayer to include any amount in income as a result of the transfer and use of transferred assets to provide medical and dental benefits to Union-represented retirees.

RULING REQUEST 3:

Taxpayer represents that all deductions made with respect to Pre-DEFRA Contributions were made in accordance with section 162. With respect to amounts attributable to Pre-DEFRA Contributions, under section 4976(b)(3), section 4976(b)(1)(C) does not apply to amounts attributable to contributions to a fund that were not allowable as a deduction under section 419. Accordingly, amounts attributable to contributions made prior to the effective date of section 419 are not subject to the section 4976(b)(1)(C) excise tax. Consequently, with respect to the transfer of assets attributable to Pre-DEFRA Contributions from the retiree life insurance reserve to the retiree health reserve in Trust, and the use of the transferred assets to provide retiree health benefits, will not result in a "disqualified benefit" within the meaning of section 4976(b)(1)(C), and therefore will not in and of itself cause Taxpayer to be liable for the excise tax imposed by section 4976.

Taxpayer represents that all deductions for Post-DEFRA Contributions to Trust were in accordance with section 419A(f)(5). Amounts attributable to Post-DEFRA Contributions will not revert to Taxpayer because those amounts will be used by Trust to provide collectively bargained post-retirement medical benefits. Consequently, with respect to Post-DEFRA Contributions, the transfer of such assets from the retiree life insurance reserve in Trust to the retiree health reserve in Trust, and the use of the transferred assets to provide retiree health benefits, will not result in a "disqualified benefit" within the meaning of section 4976(b)(1)(C), and therefore will not in and of itself cause Taxpayer to be liable for the excise tax imposed by section 4976.

RULINGS:

Based on the information submitted, representations made, and the authorities cited above, we conclude that;

1. The transfer of assets from the retiree life insurance reserve to the retiree health reserve in Trust will not cause Taxpayer to include any amount in gross income under section 61.

2. The use of transferred assets to provide medical and dental benefits to Union retirees covered by Plan B will not cause Taxpayer to include any amount in gross income under section 61.

3. The transfer of assets from the retiree life insurance reserve to the retiree health reserve in Trust, and the use of the transferred assets to provide retiree health benefits, will not result in any "disqualified benefit" within the meaning of section 4976(b)(1)(C), and will not, in and of itself, cause Taxpayer to be liable for the excise tax imposed by section 4976.

This ruling will be made available for public inspection under section 6110 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) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, EO Technical

Enclosure
Notice 437