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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
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Date:
April 08, 2015

Legend:

Taxpayer =

Trust =

Plan =

Date X =

$X =

$Y =

$Z =

Dear :

This responds to your letter dated April 25, 2014, and subsequent correspondence, requesting a ruling regarding the tax consequences of an amendment to Trust, which you represent is a voluntary employees' beneficiary association under section 501(c)(9) of the Internal Revenue Code (Code). The amendment would permit some of Taxpayer's assets, now dedicated to post-retirement health benefits, to be used to provide health benefits to active employees.

FACTS

Taxpayer sponsors Trust, which holds assets used to provide post-retirement health benefits under Plan to eligible employees who retire from Taxpayer. Trust and Plan were established on Date X. Section 2.3 of Trust provides that "[n]o benefits shall be paid out of [Trust] which would cause [Taxpayer] to be subject to tax for the payment of disqualified benefits under Section 4976 of the Code." Section 2.3(c) of Trust specifically prohibits "any portion of [Trust] reverting to the benefit of [Taxpayer]." Taxpayer has contributed a total of $X to Trust, and Trust had $Y in assets as of December 31, 2014. Taxpayer represents that it deducted contributions to Trust in accordance with section 419A(c)(2) of the Code.

Taxpayer intends to amend Trust to include active employees of Taxpayer as an additional class of participants entitled to receive health benefits under Plan. The amendment will provide that $Z of Trust to be used to provide health benefits to active employees will be segregated in a separate subpart of Trust and used exclusively for such benefits. Taxpayer further represents that it will recognize $Z in income under the tax benefit rule.

RULING REQUESTED

Taxpayer has requested a ruling that the amendment of Trust and the use of Trust assets to provide health benefits to active employees will not result in a reversion to Taxpayer within the meaning of section 4976(b)(1)(C), and, therefore, will not cause Taxpayer to be subject to excise tax under section 4976.

LAW

Section 61(a) of the Code provides that, unless otherwise excepted, gross income includes 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 the 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 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).

Section 419A(a) provides that the term “qualified asset account” means any account consisting of assets set aside to provide for the payment of (1) disability benefits, (2) medical benefits, (3) SUB or severance pay benefits, or (4) life insurance benefits.

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

Section 419A(c)(1) provides that, except as otherwise provided in this subsection, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund (A) claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in subsection (a), and (B) administrative costs with respect to the claims.

Section 419A(c)(2) provides that the account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees.

Section 4976(a) of the Code 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.

ANALYSIS AND CONCLUSION

As explained 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 National Bank, 460 U.S. at 385.

The amendment of Trust will allow amounts that were originally set aside to provide retiree health benefits to be used to provide health benefits for active employees. The contributions made by Taxpayer were originally deducted as part of a reserve for post-retirement medical benefits under section 419A(c)(2). Thus, the amendment of Trust will implicate the tax benefit rule because Taxpayer deducted the contributions for retiree health benefits in a prior year, but after the amendment the amounts attributable to the contributions will be available to provide benefits for active employees, which is fundamentally inconsistent with the premise of the deduction. Taxpayer has therefore represented that it will include in income $Z, which is the amount that will be available under the Trust amendment for the payment of health benefits for active employees.

As explained above, 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. A "disqualified benefit" is defined in section 4976(b)(1)(C) to include any portion of a welfare benefit fund reverting to the benefit of the employer. Based on the information submitted by Taxpayer, it does not appear that the amendment of Trust or use of Trust assets to provide health benefits for active employees will result in any portion of Trust reverting to the benefit of Taxpayer. Thus, the amendment of Trust and the use of Trust assets to provide health benefits to active employees will not result in a "disqualified benefit" within the meaning of section 4976(b)(1)(C), and the transaction will not, in and of itself, cause Taxpayer to be liable for the excise tax imposed by section 4976.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Janet A. Laufer
Senior Technician Reviewer
Health & Welfare Branch
Office of Associate Chief Counsel
(Tax Exempt & Government Entities)