OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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CC:TEGE:EB:HW:LDMasano
PRENO-111087-02

MEMORANDUM FOR ROBERT FONTENROSE
T:EO:RA:QAG MANAGER, EO TECHNICAL GUIDANCE AND QUALITY ASSURANCE
Attn: Lee Phaup

FROM: Janet Laufer
Senior Technician Reviewer, Qualified Plans Branch 1
Associate Chief Counsel/Division Counsel
(Tax Exempt & Government Entities)

SUBJECT: [redacted]

This memorandum is in response to your request for technical assistance with respect to a private letter ruling request concerning the tax consequences under sections 61, 4976, and 420 of the Internal Revenue Code (the Code) of four sets of transactions planned by [redacted] involving several welfare benefit plans that provide benefits to [redacted] employees and retirees. Specifically, you ask that we provide our legal conclusions concerning the following rulings requested by [redacted]

1) Ruling Request #2: The proposed transactions will not cause [redacted] to include any amount in gross income.

2) Ruling Request #5: As of the end of a plan year with respect to any plan included under [redacted] Voluntary Employee Benefits Associations (VEBAs), the assets then held in the retired lives reserves by the VEBAs will not be treated as assets "set aside to pay for the qualified current retiree health liability" for purposes of Section 420(e)(1)(B).

3) Ruling Request #6: The proposed transaction involving use of excess postretirement life insurance benefits for postretirement health insurance benefits will not be deemed inconsistent with, or violate, any representations made by the taxpayer that the [redacted] retired lives reserve will "be used exclusively to provide post retirement life insurance benefits and to pay related administrative expenses" associated with a previous private letter ruling received by [redacted]

FACTS

Presently, funds postretirement life insurance benefits for employees who meet certain age and service requirements through the " a tax exempt VEBA qualified under section 501(c)(9) of the Code. The holds a retired lives reserve (RLR) that is maintained under the a life insurance policy ( ), which is currently held by the 's first proposed transaction is to divide the into two separate VEBAs (the " " and the " collectively, the "New VEBAs"), one providing postretirement life benefits to represented employees and another providing postretirement life benefits to nonrepresented[1] employees. In accordance with this division, the will be amended to exclude nonrepresented employees, and assets of the RLR that are attributable to nonrepresented employees will be transferred to a separate retired lives reserve under a new, essentially identical policy that will be issued to the VEBA providing benefits to those employees. The and the new policy establisbed to provide benefits to nonrepresented employees are referred to below as the " ." The RLR and the new RLR established to hold assets attributable to represented and nonrepresented employees are referred to below as the "New RLRs." Both resulting trusts (the New VEBAs) and the s thereunder will contain provisions that the New RLRs will be used exclusively to provide postretirement life insurance benefits and to pay related administrative expenses (with the exception of amounts released to pay for postretirement health benefits as described below) and prohibiting any amount held in the New VEBAs from reverting to .

The assets in the RLR were originally transferred in from a retired lives' reserve maintained by as a consequence of 's reorganization that resulted in a spin-off of . The was fully funded when the assets were transferred to the RLR, and as a result has not made any contributions to the VEBA (nor taken any corresponding deductions). The remains fully funded with excess assets of approximately $ ( ). represents that the represent contributions made and accruals occurring prior to . defines " " as the lesser of the " s" and the "

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[1]"Represented employees" are those covered by a collective bargaining agreement and "nonrepresented employees" are those not covered by a collective bargaining agreement as described in 's request for a private letter ruling dated .

Reserves." [redacted]" are defined as the total ([redacted] and [redacted]) asset values less the total ([redacted] and [redacted]) present value of life insurance benefit obligations.[2]

Once [redacted] separates the [redacted] into the New VEBAs, it plans to use the Excess Pre-DEFRA Reserves available in the New VEBAs for the purpose of funding [redacted] postretirement health benefits for the employees covered by each postretirement life insurance benefit fund. In accordance with a representation made in a prior letter ruling relating to the spinoff of [redacted] from [redacted], the [redacted] states that the RLR assets will be used exclusively to provide postretirement life insurance benefits and to pay related administrative expenses. Accordingly, each of the [redacted] will be amended to allow the RLR assets to be used to fund postretirement health benefits.

[redacted] will maintain the assets to be used to fund postretirement health benefits in a separate account within each of the established New VEBAs. The amount of the [redacted] that may be released from the New RLRs in each of the New VEBAs in any taxable year will be determined by [redacted] on a day during such year and such amount may or may not be released upon [redacted] election, from the applicable retired lives reserve thereafter and set aside in a separate postretirement health benefit within the corresponding VEBA. During any year, any portion of the [redacted] that [redacted] does not elect to set aside for postretirement health benefits will be used only to provide postretirement life insurance benefits during that year.

Upon the establishment of the New VEBAs and the adoption of amendments allowing the release of the [redacted] from the RLR to be used for postretirement health benefits, [redacted] also plans to amend its welfare benefit plans so that a single welfare benefit plan will cover all eligible [redacted] retired employees for retiree life and health benefits. The postretirement health benefits for the single retiree welfare benefit plan would then be funded by three separate sources: (1) [redacted] which fund postretirement health benefits for represented and non-represented employees; (2) the New VEBAs from which, from time to time (as described above), portions of the [redacted] will be set aside to pay postretirement health benefits for represented and non-represented employees; and (3) [redacted] qualified defined benefit pension plans from which, from time to time, [redacted] transfers excess assets pursuant to section 420 of the Code to a retiree health account

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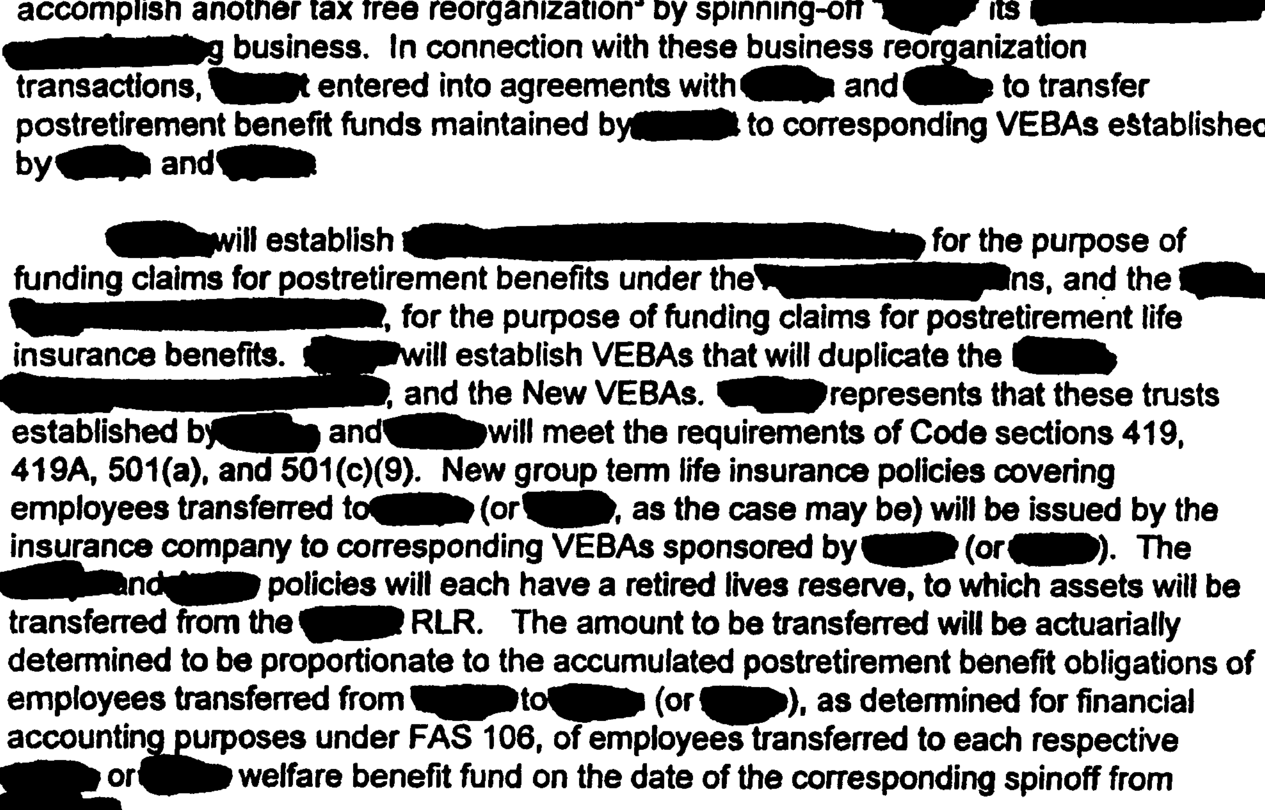
[2] The private letter ruling request does not describe how the [redacted] are calculated. See discussion under "Issue 1" below concerning this calculation.

described in section 401(h) of the Code (401(h) Account) to pay postretirement health benefits for represented and non-represented employees.



s in the process of restructuring its business operations and to accomplish this, completed a tax free reorganization in by spinning-off " its s business. In addition, plans to accomplish another tax free reorganization[3] by spinning-off " its g business. In connection with these business reorganization transactions, t entered into agreements with and to transfer postretirement benefit funds maintained by to corresponding VEBAs established by and

will establish for the purpose of funding claims for postretirement benefits under the ns, and the , for the purpose of funding claims for postretirement life insurance benefits. will establish VEBAs that will duplicate the , and the New VEBAs. represents that these trusts established by and will meet the requirements of Code sections 419, 419A, 501(a), and 501(c)(9). New group term life insurance policies covering employees transferred to (or , as the case may be) will be issued by the insurance company to corresponding VEBAs sponsored by (or). The nd policies will each have a retired lives reserve, to which assets will be transferred from the RLR. The amount to be transferred will be actuarially determined to be proportionate to the accumulated postretirement benefit obligations of employees transferred from to (or), as determined for financial accounting purposes under FAS 106, of employees transferred to each respective or welfare benefit fund on the date of the corresponding spinoff from

LAW AND ANALYSIS

Issue 1: Whether the proposed transactions will requir t to include any amount in gross income.

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

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[3] received a private letter ruling that the spin-off of constituted a tax-free reorganization. However, has received no ruling concerning the proposed spin-off of

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. That section, in part, codifies the "tax benefit rule". Generally, the tax benefit rule requires the inclusion in income of certain amounts that were deducted in a prior year and that generated a tax benefit through a reduction in the amount of tax liability in the prior tax year. *Estate of Block v. Comm'r, 39 B.T.A. 338 (1939),* aff'd sub nom. *Union Trust Co. v. Comm'r, 111 F.2d 60 (7th Cir. 1939),* cert. denied, *311 U.S. 658 (1940); Rev. Rul. 85-186, 1985-2 C.B. 84.* In *Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983),* the Supreme Court held, in part, that income may arise under the tax benefit rule even though there is no actual recovery of funds that were previously deducted, if an event occurs that is "fundamentally inconsistent" with the premise on which a deduction was taken in a prior year.

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 section 419 and section 419A of the Code. 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 of the Code 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 funds were controlled by section 162 of the Code.

Section 1.162-10 of the Income Tax Regulations 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.

Rev. Rul. 69-478, 1969-2 C.B. 29, holds that a corporation'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. 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. 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 in the taxable year paid or incurred but only to the extent that such contributions are actuarially determined and made on a level basis.

One proposed transaction involves funding postretirement health benefits for employees from amounts originally attributable to contributions made to fund postretirement life benefits for which deductions were previously taken pursuant to section 162 of the Code. Also, plans to transfer assets relating to nonrepresented employees from the insurance policy within the (which will cover only represented employees once the transaction occurs), to a new substantially identical policy within the New VEBA providing benefits to nonrepresented employees. Additionally, will transfer assets to new welfare benefit plans established to provide life insurance benefits by the two spun-off corporations, and , in an amount proportionate to the accumulated postretirement benefit obligations of employees transferred to and , respectively. When amounts were originally contributed to the (or the trust that previously held the assets), deductions were taken in accordance with sections 162 and 419 of the Code.

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 rule protects the Government and taxpayers from the adverse effects of reporting a transaction on the basis of assumptions that an unforeseen event in a subsequent year proves to have been erroneous. However, not every unforeseen event will require the taxpayer to report income in the amount of the prior deduction. Rather, the tax benefit rule will "cancel out" a prior deduction only when the subsequent event is indeed "fundamentally

inconsistent with the premise on which the deduction was based. That is, if that event had occurred within the same taxable year [as the deduction], it would have foreclosed the deduction." Hillsboro, 460 U.S. at 383-84 [footnote omitted]. The facts and circumstances of each case must be considered "in light of the purpose and function of the provisions granting the deductions." Id. at 385.

[redacted] represents that all of the [redacted] are amounts contributed or accruing prior to the enactment and applicability of section 419 of the Code. As such, all deductions for these contributions would have been taken under section 162 of the Code for ordinary and necessary business expenses limited by the rules set out in Rev. Rul. 69-382 and Rev. Rul 73-599. The transfer of funds from the [redacted] RLR to the separate postretirement health account within the VEBA results in a transfer of assets from an account that provides welfare benefits to another that provides welfare benefits. For the deduction taken under section 162 of the Code for a contribution to a welfare benefit fund prior to the enactment of section 419 of the Code, no distinction was made between the type of welfare benefit provided under the fund. However, the deduction taken under section 162 of the Code was not unlimited. Rather, when originally taken, the deduction under section 162 of the Code for contributions to [redacted] RLR was limited to an amount actuarially determined to allocate the cost of the postretirement life insurance coverage provided over the working lives of the employees involved.

If the amounts in the [redacted] RLR that were set aside to fund postretirement life insurance benefits had been released to fund postretirement health benefits in the same years in which [redacted] took deductions under section162 for contributions to the RLR, that release would not have, in and of itself, foreclosed the deductions. However, because the limit on the amount of the deduction in each of those years would have been different depending on whether the contributions were applied to fund postretirement life insurance benefits or postretirement health benefits, more information is needed from [redacted] in order to determine whether the application of the tax benefit rule results in gross income to [redacted] in this case. Specifically, the amount of the contribution in each year that would have been deductible for funding postretirement life benefits (i.e., up to the amount that would fairly allocate the cost of postretirement life insurance over the working lives of the employees involved) may have exceeded the amount that would have been deductible for funding postretirement health benefits over the working lives of the employees involved. If excess [redacted] are attributable to amounts deducted by [redacted] for contributions that did not exceed the amount that would have been deductible if used to fund postretirement health benefits over the working lives of the employees involved for the years in which the respective deductions were taken, the release to the separate accounts within each

of the New VEBAs to provide postretirement health benefits is not fundamentally inconsistent with the deductions taken under section 162 of the Code, and therefore, the application of the tax benefit rule would not result in gross income to

With regard to the transfer of assets from the to the life insurance policy in the New VEBA covering only the nonrepresented employees, the life insurance benefits in the New VEBAs will maintain the provision that trust amounts will only be used to provide postretirement life insurance benefits and to pay related administrative expenses (with the exception of the amendment to allow the release of amounts to pay for retiree health benefits as discussed above). Additionally, these trusts and the life insurance policies thereunder contain provisions prohibiting the reversion of any amount held in the retirement funding account to as long as any employee or retiree of remains alive. These provisions are

effective to preserve the integrity of the assets transferred to the New VEBA covering nonrepresented employees. Accordingly, this transaction will not be fundamentally inconsistent with the deductions taken in previous years with respect to those assets, and the application of the tax benefit rule would not result in gross income to Similarly, the transfer of the proportionate assets to the New VEBA that provides retiree life benefits to nonrepresented employees, from the subject to the limitation that funds in those trusts be used exclusively to provide postretirement life insurance benefits, and to pay related administrative expenses, except to the extent that are released to pay postretirement health benefits and related administrative expenses, will not result in a reversion to the benefit of that is subject to the excise tax imposed by section 4976.

In considering the implications of the tax benefit rule to proposed transactions, we did not make any determinations concerning implications of the tax benefit rule due to unrelated business income of the VEBAs which have funded and s postretirement benefits in the past. Accordingly, you should include in the

ruling a disclaimer that, "no opinion is expressed about the implications of past computation of the account limit under section 419A(c) for purposes of computing the unrelated business income under section 512(a)(3) of the Code of the [redacted] or any prior trusts to which assets now in the [redacted] were originally contributed."

Issue 2: Whether, as of the end of a plan year with respect to any plan included under [redacted] Voluntary Employee Benefits Associations (VEBAs), remaining New RLR assets will be treated as assets "set aside to pay for the qualified current retiree health liability for purposes of Section 420(e)(1)(B)."

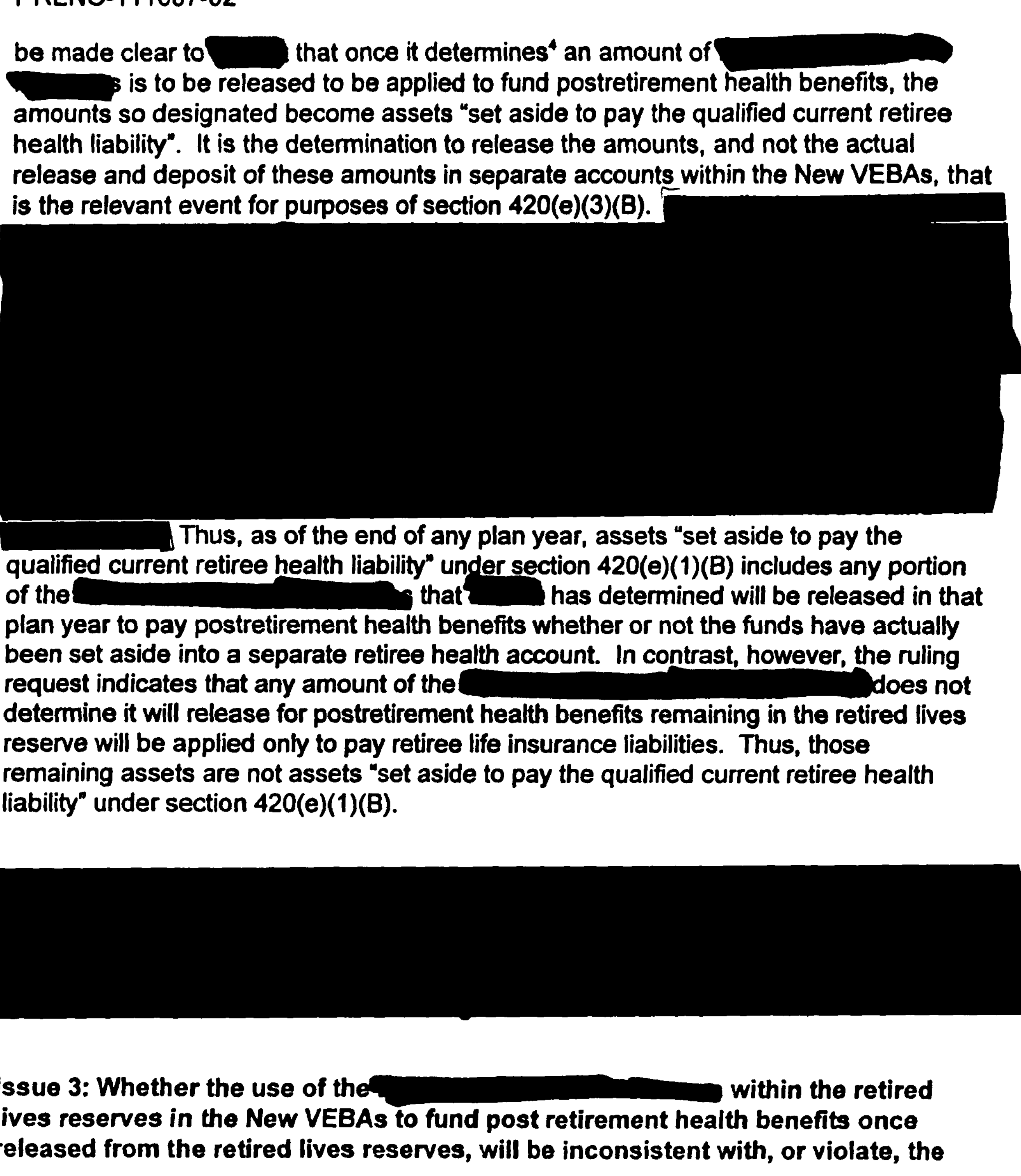
Section 420 permits, subject to specified conditions and limitations, a qualified transfer of excess pension assets of a defined benefit plan (other than a multiemployer plan) to a health benefits account (under section 401(h)) that is part of the plan. Section 420(b)(3) limits the amount that may be transferred to the amount that is reasonably estimated to be the amount the employer maintaining the plan will pay (whether directly or through reimbursement) out of the account during the taxable year of the transfer for qualified current retiree health liabilities.

Section 420(e)(1)(A) provides that, generally, the term "qualified current retiree health liabilities" means, with respect to any taxable year, the aggregate amounts (including administrative expenses) that would have been allowable as a deduction to the employer for the taxable year with respect to applicable health 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 420(e)(3)(B) provides that the amount determined under section 420(e)(1)(A) shall be reduced by amounts in health benefits accounts or welfare benefit funds set aside to pay for the qualified current retiree health liability. This reduction is based on the ratio of (i) the value, as of the close of the plan year preceding the section 420 transfer, of the assets in all health benefits accounts or welfare benefit funds set aside to pay for qualified current retiree health liabilities, to (ii) the present value of the qualified current retiree health liabilities for all plan years.

During any taxable year, once [redacted] has determined an amount of [redacted] in the New VEBAs may be released to be applied to fund postretirement health benefits and related expenses in a taxable year, those amounts are committed to pay current retiree health liabilities for that year. Accordingly, it should

be made clear to that once it determines[4] an amount of is to be released to be applied to fund postretirement health benefits, the amounts so designated become assets "set aside to pay the qualified current retiree health liability". It is the determination to release the amounts, and not the actual release and deposit of these amounts in separate accounts within the New VEBAs, that is the relevant event for purposes of section 420(e)(3)(B).



Thus, as of the end of any plan year, assets "set aside to pay the qualified current retiree health liability" under section 420(e)(1)(B) includes any portion of the that has determined will be released in that plan year to pay postretirement health benefits whether or not the funds have actually been set aside into a separate retiree health account. In contrast, however, the ruling request indicates that any amount of the does not determine it will release for postretirement health benefits remaining in the retired lives reserve will be applied only to pay retiree life insurance liabilities. Thus, those remaining assets are not assets "set aside to pay the qualified current retiree health liability" under section 420(e)(1)(B).

Issue 3: Whether the use of the within the retired lives reserves in the New VEBAs to fund post retirement health benefits once released from the retired lives reserves, will be inconsistent with, or violate, the

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[4] application does not describe how the determination is made. We are assuming it would be by resolution of board of directors. This is something you may wish to clarify with prior to issuing a PLR.

representations made by for the purpose of obtaining the Private Letter Ruling in 1996 and will not adversely affect such ruling.

Although you did not request our assistance concerning ruling request #3 regarding the application of section 4976 of the Code to the proposed transactions set forth above, that issue relates to issues addressed in PLR 9701011, and, accordingly, we are addressing that issue here.[5] 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 plan. Section 4976(b)(1)(C) indicates that the term "disqualified benefit" includes "any portion of a welfare benefit fund reverting to the benefit of the employer." Section 4976(b)(3) of the Code 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.

The Service previously issued PLR 9701011 regarding the transfer of amounts from welfare benefit funds to similar welfare benefit funds established by

[5] Above we address the application of section 4976 to the transfer of assets by o the New VEBAs to provide postretirement life insurance benefits to nonrepresented employees from the New VEBAs (or depending on the timing of the transaction) to corresponding VEBAs established by and

The rulings in that PLR were based in part upon representations by that the amounts transferred to the RLR would be used exclusively to provide postretirement life insurance benefits and to pay related administrative expenses. now represents that the life insurance policies held by the New VEBAs will provide that the RLR assets will be used exclusively to provide postretirement life insurance benefits and to pay related administrative expenses, except to the extent that are released to pay postretirement health insurance benefits and related administrative expenses as described above. Because, as indicated above, section 4976 is not applicable with respect to the use of we conclude that the proposed transactions will not adversely affect the determinations in PLR 97010011.

If you have any questions regarding this memorandum, please contact at or me at .