Office of Chief Counsel
Internal Revenue Service

memorandum

CC:TEGE:EB:QP1
CAVohs
PLR-146256-02

date: March 3, 2003

to: Joseph Chasin
Reviewer
EO Rulings and Agreements (Technical Group 2)

from: MARK I. SCHWIMMER
Senior Technican Reviewer
(Tax Exempt and Government Entities)

---

subject: **Ruling Request -** [redacted]

This document is being provided in response to your request for assistance regarding a ruling request submitted by [redacted] Assuming that the facts you have developed are consistent with the facts set forth in Attachment A, the law and analysis set forth in Attachment B may be used in the body of your ruling.

If you have questions regarding this information, please call Cathy Vohs at 622-4145.

Attachments (2)

ATTACHMENT A

FACTS

LEGEND:

Taxpayer = [redacted]
Company X = [redacted]
Company Y = [redacted]
Policy 1 = [redacted]
Policy 2 = [redacted]
Policy 3 = [redacted]
Reserve = [redacted]
State M = [redacted]
Date A = [redacted]
Date B = [redacted]
Date C = [redacted]
Date D = [redacted]
Trust M = [redacted]
Voluntary
Trust N = [redacted]
Group Health Plan = [redacted]

The Taxpayer, a life insurance company, is an accrual method taxpayer and is a member of an affiliated group of corporations, the common parent of which is Company X. As of Date A, most employees of the Taxpayer were transferred to Company Y, a newly created services company that is a direct and wholly-owned subsidiary of Company X and a member of the same affiliated group of corporations. Company X is an accrual method taxpayer and files a consolidated federal income tax return on a calendar year basis.

Under a services contract between the Taxpayer and Company Y, Company Y employees (former employees of the Taxpayer and newly hired employees) will perform services for the Taxpayer, and in return, Company Y will be compensated by the Taxpayer for the employee costs (salary and benefits) attributable to such Company Y employees. The Taxpayer intends that all transferred employees have the same level of employee benefit coverages that they would have had if they had remained employed by the Taxpayer. Thus, in the case of the Taxpayer's retiree health plan, the transferred employees will have the same eligibility standards and receive the same employer cost subsidies as they would have had with the Taxpayer. In furtherance of this, Company Y will adopt and sign on to the Taxpayer's retiree medical plan as a participating employer for its own employees. Company Y also will sign on as a participating employer to the Taxpayer's group health insurance plan and current VEBAs.

The Taxpayer maintains the Group Health Plan for the benefit of its active and retired employees (and their dependents), as well as the active and retired employees (and their dependents) of its affiliated companies. The Taxpayer subsidizes the active and retiree medical coverages. The amount of the subsidy is determined based on a number of factors including length of service, number of covered dependents and eligibility for Medicare.

Part of the retiree coverage under the Group Health Plan is insured under the following policies issued by the Taxpayer:

1. Policy 1 (for all active employees, disabled employees and retirees on or after January 1, 1991);
2. Policy 2 (for all employees who retired or became disabled prior to January 1, 1991 (excluding residents of State M); and
3. Policy 3 (for employees who were residents of State M and retired or became disabled prior to January 1, 1991).

Under the above-listed policies, the Taxpayer maintains the Reserve, which is a welfare benefit fund under section 419(d) of the Internal Revenue Code (Code), to provide post-retirement medical benefits for eligible retirees. Each policy provides that the Reserve is to be used exclusively to provide post-retirement medical benefits to eligible retirees who are not key employees under the Code. The policies also provide that, in the event that such policies are terminated, any balance remaining in the Reserve is to be used to provide continuing post-retirement medical coverage for as long as any eligible retiree remains alive. At the time of death of the last surviving eligible retiree, any balance in the reserve shall then be used, as permitted by applicable law, for the sole benefit of active or retired employees of the Taxpayer.

The Reserve consists of two account balances -- one maintained for the non-represented retirees and the other for represented retirees -- which are used to pay the retiree medical benefits for its respective members. As of Date B, the balance in the Reserve for non-represented retirees was approximately $x, and for represented retirees it was $y.

The Taxpayer also maintains two VEBA trusts to provide funding for post-retirement medical benefits. Trust M was established on Date C and provides for funding of (1) post-retirement medical benefits for eligible non-represented retirees (other than key employees as defined in section 419A(d)(3) of the Code, and (2) certain other benefits for these retirees, which may be designated by the Taxpayer from time to time, including life, sick, accident and other similar benefits. Trust N was established on Date D and provides for the funding of (1) post-retirement medical benefits for eligible represented retirees (other than key employees as defined in section 419(A)(b)(3), and (2) certain other benefits for these retirees, which may be provided under a Trust which is tax exempt under section 501(c)(9).

Under the terms of Trust M and Trust N, all contributions to the Trusts and all earnings on those contributions must be used for the exclusive benefit of eligible retirees identified therein. Moreover, under each Trust, upon termination, any balance remaining in the Trust must be used to provide post-retirement medical benefits under the Group Health Plan for as long as any eligible retiree (or their dependents) remains alive and covered by the Group Health Plan. At the time of the death of the last surviving eligible retiree, any balance in the Trust shall be used, as permitted by applicable law, for the sole benefit of the active or retired employees of the Taxpayer.

In order to simplify the administration of the Group Health Plan, and provide greater flexibility, the Taxpayer intends to transfer up to all of the amounts held in the Reserve for non-represented retirees to Trust M and up to all of the amounts held in the Reserve for represented retirees to Trust N.

RULINGS REQUESTED

The Taxpayer requests rulings with respect to the proposed transaction:

1. Neither the transfer of amounts held in the Reserve from the Taxpayer to Trust M and Trust N, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will result in the realization or recognition of gross income or gain to the Taxpayer under sections 61 or 1001 of the Code

2. Neither the transfer of amounts held in the Reserve from the Taxpayer to Trust M and Trust N, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will constitute a reversion subject excise tax under section 4976 of the Code.

ATTACHMENT B

LAW AND ANALYSIS

Section 61(a) of the Code provides that, unless otherwise excepted, gross income includes all income from whatever source derived, including income from life insurance and endowment contracts.

Section 419 of the Code provides rules with respect to the tax treatment of welfare benefit funds. Section 419(a) provides that contributions paid or accrued by an employer to a welfare benefit fund, if they would otherwise be deductible, shall be deductible (subject to limitations) under section 419 for the taxable year in which paid.

Section 419(e)(1) of the Code 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 to the extent provided in regulations, any account held for an employer by any person.

Under section 1.419A-1T(c), Q&A-3 of the Federal Income Tax Regulations, a retired lives reserve maintained by an insurance company is a "fund" or part of a "fund," if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years' benefits costs or insurance premiums.

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 fund.

Section 4976(b)(1)(C) of the Code provides that the term "disqualified benefit" includes any portion of a welfare benefit fund reverting to the benefit of the employer.

Revenue Ruling 69-382, 1969-2 C.B. 28, holds, in part, 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 were deductible in full even though a portion of the premium was credited to a retired reserve if (1) the balance in the reserve was held by the insurance company solely for the purpose of providing insurance coverage on active and retired lives so long as any active or retired employees remained alive, and (2) the amount added to the retired lives reserve was not greater than an amount that would be required to fairly allocate the cost of the insurance coverage provided over the working lives of the employees involved. Further, the ruling holds, in pertinent part, that these conclusions would be applicable to taxable years ending after June 17, 1969, provided that the employer policyholder promptly amended the contract to provide that it did not retain any right to recapture any portion of the reserve so long as any active or retired employee remains alive.

In Revenue Ruling 73-599, 1973-2 C.B. 40, 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. 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(a)(9) of the Code. 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 purposed of providing insurance coverage for retired employees. Under these facts, the ruling holds that the balance in the retired reserve was includable in the employer's gross income under section 61(a) in the year of 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.

Similarly, in Revenue Ruling 77-92, 1977-1 C.B. 41, 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 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 of those funds to another insurance company rather than to a trust that qualified for exemption under section 501(a)(c)(9) of the Code. 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 federal income tax rules apply to the transfers in the two cases.

In the present case, all amounts transferred to Trust M and Trust N from the Reserve will be credited to a separate account for post-retirement medical benefits and used exclusively for the payment of post-retirement medical benefits. Policies 1, 2, and 3 clearly prohibit the reversion of any amounts held in the Reserve thereunder to the Taxpayer as long as any eligible employee or retiree of the Taxpayer remains alive. Moreover, Trusts M and N, the trusts that will receive the Reserve proceeds, contain similar provisions prohibiting any reversion of the Trusts' assets to the Taxpayer while any eligible employees or retirees of the Taxpayer remain alive. In addition, under

Policies 1, 2, and 3, and under Trusts M and N, after the death of the last surviving eligible retiree under the Health Plan, any balance remaining in the Reserve or Trusts must be used for the sole benefit of active or retired employees (as permitted by law). These provisions preclude the Taxpayer from receiving a reversion from either the Reserve or the Trusts, and thus distinguish this case from the revenue rulings discussed above. Accordingly, unlike the taxpayers in those revenue rulings, the transfer by the Taxpayer from the Reserve to the Trusts should not give rise to taxable income under sections 61 and 1001, nor should it be considered a reversion to the Taxpayer under section 4976.

CONCLUSIONS

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

1. Neither the transfer of amounts held in the Reserve from the Taxpayer to Trust M and Trust N, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will result in the realization or recognition of gross income or gain to the Taxpayer under sections 61 or 1001 of the Code.

2. Neither the transfer of amounts held in the Reserve from the Taxpayer to Trust M and Trust N, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will constitute a reversion subject excise tax under section 4976 of the Code.