Internal Revenue Service
memorandum

CC:EBEO:4
JLaufer FREV-108731-99

date: JUL 1 3 1999

to: Director, Exempt Organizations CP:E:EO

from: Assistant Chief Counsel (Employee Benefits and Exempt Organizations)
CC:EBEO

subject: [redacted]
FREV-108731-99

You have requested our assistance in connection with the above-referenced ruling request. Specifically, you have asked us to address issues raised by the Taxpayer regarding the application of section 4976 and section 61 of the Internal Revenue Code. Ms. Janet Laufer of my staff explained to John Chappell of your staff in a telephone conversation on July 12, 1999, that the ruling request does not contain sufficient information to form a basis for addressing Taxpayer's questions regarding the application of section 419A(c) of the Code to the proposed transaction, and that you should coordinate with the Employee Plans Division on those questions since that Division has ruling jurisdiction over section 419A(c).

FACTS

The [redacted] Trust) has received a determination letter that it is exempt from taxation as a voluntary employees' beneficiary association (VEBA) under section 501(c)(9) of the Code. The purpose of the [redacted] Trust is to provide a funding mechanism for employee welfare benefits provided under the [redacted] (Program). [redacted] a subsidiary of Taxpayer, maintained the [redacted] Trust), also a VEBA. The [redacted] Trust contained assets consisting solely of after-tax employee contributions used to provide long-term disability benefits to participants of the [redacted] Disability Plan). Effective December 31, 1996, the [redacted] Trust was terminated, and its assets were transferred to the [redacted] Trust. All assets transferred from the [redacted] Trust were deposited into a subaccount within the [redacted] Trust known as the [redacted] Account". Pursuant to the [redacted] Trust, a portion of the assets of the [redacted] Account was used to purchase an annuity contract to provide continuing long-term disability benefits to persons receiving benefits under the [redacted] Disability Plan on [redacted]. The [redacted] Trust further provides that after purchase of the annuity contract, the [redacted] Account may be used to fund any Code section 501(c)(9) permissible benefits for active employee participants in the [redacted] Trust who were also participants in the [redacted] Trust. The [redacted] Account assets have not been used for any purpose other than to purchase the annuity contract.

Former participants of the [redacted] Trust who are active employees of Taxpayer and its affiliates now receive long-term disability coverage under Program. Long-term disability benefits provided under Program are substantially equal to long-term disability benefits provided under the [redacted] Trust.

Taxpayer's request further states that it is "administratively impossible to trace assets of the [redacted] Account to particular contributing employees and former employees." Taxpayer proposes to amend the [redacted] Trust to transfer the [redacted] Account assets from the [redacted] Account to the remainder of the [redacted] Trust, and use the transferred assets to provide permissible section 501(c)(9) benefits to all participants in the [redacted] Trust.

Taxpayer asks for a ruling that the proposed use of amounts in the [redacted] Account to provide permissible section 501(c)(9) benefits to all participants in the [redacted] Trust will not be considered a prohibited reversion under section 4976(b)(1)(C) of the Code that would be subject to the excise tax under section 4976(a) of the Code. Taxpayer also requests a ruling that the proposed use of assets will not result in the realization or recognition of gross income by Taxpayer, the VEBA, or any participant or beneficiary thereunder.

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 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 tax 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 in part held 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.

Section 419(a) of the Code governs an employer's deductions for contributions paid or accrued by an employer to a welfare benefit fund. After-tax employee contributions to a welfare benefit fund are not allowable as a deduction to the employer.

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) provides that the term "disqualified benefit" means --

> (A) any post-retirement medical benefit or life insurance benefit provided with respect to a key employee if a separate account is required to be established for such employee under section 419A(d) and such payment is not from such account,
>
> (B) any post-retirement medical benefit or life insurance benefit provided with respect to an individual in whose favor discrimination is prohibited unless the plan meets the requirements of section 505(b) with respect to such benefit (whether or not such requirements apply to such plan), and
>
> (C) 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.

ANALYSIS

Application of Section 4976

The [redacted] Trust consisted solely of after-tax employee contributions and earnings thereon.[1] Consequently, all amounts in the Anchor Hocking Account are

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[redacted]

attributable to after-tax employee contributions. After-tax employee contributions to a welfare benefit fund are not deductible by the employer. Thus, the [redacted] Account contains only amounts attributable to contributions to the [redacted] Trust that were not "allowable as a deduction under section 419 for the taxable year or any prior taxable year" within the meaning of section 4976(b)(3) of the Code. Accordingly, pursuant to that section, Code section 4976(b)(1)(C) does not apply to any portion of the [redacted] Account that may revert to Taxpayer.

Application of Section 61

[redacted]

The proposed use of assets should not result in the realization or recognition of gross income by Taxpayer under section 61.

[redacted]

[redacted]

[2] You may want to indicate in the ruling that the issue of whether the participants will receive income as a result of the proposed use of amounts in the Anchor Hocking Account to provide permissible section 501(c)(9) benefits will depend upon the availability of an exclusion from the participants' income under the specific sections of the Code pertaining to those benefits. The issue of income to the VEBA would be addressed in your discussion of unrelated business taxable income under section 512 of the Code.

[redacted]

If you have any questions regarding this memorandum, please contact Janet Laufer at 622-6060.

MARY OPPENHEIMER

by MARK SCHWIMMER
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