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Department of the Treasury
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PLR-125738-06
Date:
November 17, 2006

Legend

Employer =

Trust =
Plan =

Dear :

This responds to your letter of May 11, 2006 and subsequent correspondence of November 5, 2006 and November 16, 2006, requesting rulings concerning the proper Federal income tax treatment under section 106 of the Internal Revenue Code (Code) of retiree health benefits provided to eligible employees, their spouses and dependents.

Employer proposes to establish a Trust for the benefit of eligible retiring employees, their spouses and dependents. The Trust funds will be used to pay for retiree health benefits payable under the Plan. Under the Plan, retiree health benefits are limited to employees who regularly work 20 hours or more per week and who meet a 30 day waiting period. Coverage under the Plan will be automatic for eligible employees and an eligible employee cannot elect in or out of coverage.

Employer will contribute to the Trust amounts as specified in the Plan or by resolution of the Employer. No other person will be permitted to make contributions. The Employer's contribution will include the following: discretionary contributions to be made by the Employer on behalf of all participating employees; contributions of all or a portion of employees' accumulated and unused vacation and sick leave upon retirement; and contributions of all or a portion of employees' annual excess vacation and sick leave that would otherwise be forfeited or paid out at year end. In accordance with the Plan's procedures and prior to the beginning of each Plan year, the Employer will designate

the amounts for the discretionary Employer contributions to be contributed to the Trust and the percentage or fixed amount of the vacation and sick leave to be contributed to the Trust. Also, the Employer will, in its sole discretion, establish a contribution amount applicable to vacation and sick leave accrued prior to the effective date of the plan. All contribution amounts will be determined in the sole discretion of the Employer and under no circumstances will employees be permitted to decide the discretionary Employer contributions to be contributed to the Trust or the amount or percentage of their vacation and sick leave to be contributed to the Trust.

The Plan provides that under no circumstance may the retired eligible employee or the retired eligible employee's spouse or dependents receive any unused amounts at any time in cash or other benefits. Following the participant's death, unused amounts shall continue to carryover for the benefit of the participant's spouse and dependents. After the death of the surviving spouse and dependents, any amounts not applied to reimburse medical expenses will be forfeited.

Section 61(a)(1) of the Code and section 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106(a) of the Code provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the regulations states that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse, or the employee's dependents as defined in section 152 of the Code. The employer may contribute to an accident or health plan either by paying the premium on a policy of accident or health insurance covering one or more of the employees, or by contributing to a separate trust or fund which provides accident or health benefits directly or through insurance to one or more of the employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, section 106 applies only to the portion of the contributions allocable to accident or health benefits.

Section 105(a) provides that, except as otherwise provided in section 105, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 105(b) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a)

if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in section 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in section 152). Section 1.105-2 of the regulations provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer for the prescribed medical care are excludable from gross income. Thus, section 105(b) does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care.

Part I of Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of health reimbursement arrangements (HRAs). The notice explains that a tax-favored HRA is an arrangement that (1) is paid for solely by the employer and not pursuant to a salary reduction election or otherwise under a section 125 cafeteria plan; (2) reimburses the employee for medical care expenses (as defined in section 213(d)) incurred by the employee or by the employee's spouse or dependents; and (3) provides reimbursements up to a maximum dollar amount with any unused portion of that amount at the end of the coverage period carried forward to subsequent coverage periods.

Part IV of Notice 2002-45 emphasizes that employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a section 125 cafeteria plan. An accident and health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under section 125. See also, Rev. Rul. 2002-41, 2002-2 C.B. 75; Rev. Rul. 2005-24, 2005-1 C.B. 892; Rev. Rul. 2006-36, 2006-36 I.R.B. 353. Under section 125, unused contributions at the end of a coverage period may generally not be carried forward and used in subsequent coverage periods.

Rev. Rul. 75-539, 1975-2 C.B. 45, describes two labor contracts. Contract A provides that upon retirement, an employee will receive a portion of accumulated unused sick leave credits as a cash payment or, at the election of the employee, the payment may be applied to continue the employee's participation in the employer's health plan. Contract B provides that the value of a portion of the accumulated unused sick leave credits will be used to pay for continued participation in the employer's health plan.

Rev. Rul. 75-539 holds that, under Contract A, the value of unused accumulated sick leave credits used to continue health coverage is constructively received by the retired employee under section 451 of the Code, and therefore is includible in the retired employee's gross income. Under Contract A, the amount of the premium payments is considered an employee contribution out of salary and not a contribution by the employer under section 106 of the Code. However, under Contract B, the value of unused accumulated sick leave credits, which may not be received in cash, is not constructively received by the retired employee, but is a contribution by the employer to the employer's health plan that is excludable from the retired employee's gross income under section 106 of the Code.

Rev. Rul 2005-24 describes a health reimbursement arrangement. Situation 1 of the ruling states that when an employee retires, the employer automatically and on a mandatory basis (as determined under the Plan) contributes an amount to the reimbursement plan equal to the value of all or a portion of the retired employee's accumulated unused vacation and sick leave. Relying on Rev. Rul. 75-539, the ruling concludes that the reimbursement plan described in Situation 1 is an HRA that meets the requirements for tax-favored treatment.

Based on the Trust and Plan as submitted on May 11, 2006, and as subsequently amended by submissions dated November 5, 2006 and November 16, 2006, and on the authorities cited above, we conclude that Employer contributions paid to Trust and payments made from Trust which are used exclusively to pay for eligible medical care expenses of retired employees, their spouses and dependents are excludable from the gross income of retired employees and retired employees' spouses and dependents under sections 106 and 105 of the Code.

No opinion is expressed as to the federal tax consequences of the transaction under any other section of the Code or statute other than those specifically stated above.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Harry Beker
Chief, Health and Welfare Branch
Office of Division Counsel/Associate Chief
Counsel (Tax Exempt & Government Entities)