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Person To Contact:
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Legend

Taxpayer =

State =

Trust =

Statute A =

Statute B =

Statute C =

Statute D =

Dear :

This is in reply to your letter dated August 16, 2004, in which you requested various rulings on behalf of the Taxpayer.

Taxpayer is a state-wide public employer retirement system (System). It provides retirement, disability, and death benefits to police officers and firefighters, their

surviving spouses, and dependent children and parents. Pursuant to Statute A, participation in the System is mandatory for all full-time police officers employed by State municipalities and certain full-time firefighters employed by political subdivisions of State.

The System is governed by a nine member board of trustees (Board). Pursuant to State Statute B, the membership of the Board includes four active employees, two retired employees, one member appointed by the treasurer of State, one member appointed by the governor of State and one member jointly appointed by the Speaker of the State House of Representatives and the President of the State Senate.

In order to provide medical benefits for retired police officers, firefighters, and for their spouses and dependents, the Board has created a health care plan (Plan). The Plan provides coverage through third-party insurance contracts for medical, hospital, and surgical benefits, scheduled medical benefits, prescription drug coverage, supplemental dental and vision benefits, long term care benefits, and Medicare Part B payments. The Trust is used exclusively for the purposes of paying the health coverage of retirees who participate in the Plan. There are no individual participant accounts.

All employer contributions are placed in the Trust. The sole trustee of the Trust is the Board. Monies collected from participating employers pursuant to Plan are deposited in the Trust and used to pay the cost of administering the Plan and paying premiums on behalf of participating retirees. Any income or earnings of the Trust is used to pay expenses of the Trust. The creation and administration of the Plan and the establishment of the Trust are authorized by State Statute C and State Statute D. In no case may an employer become a participating employer in the Plan unless it is a state, a political subdivision of a state or an entity the income of which is excludible from gross income under section 115 of the Internal Revenue Code (the Code).

The Board can amend or terminate the Trust at any time. Upon termination of the Trust, any amount remaining in the Trust will be used solely to satisfy any remaining debts or liabilities of the Trust or to meet the obligations of participating employers to their participating employees under Plan. No portion of the principal or income of the Trust shall be used for or diverted to any purpose other than the exclusive benefit of persons participating in Plan and their eligible spouses and dependents and the payment of reasonable expenses of the Plan and the Trust.

You have requested the following rulings on behalf of the Taxpayer:

- (1) The Trust's income is excluded from gross income under section 115(1);
- (2) Employer contributions paid to the Trust are excludable from the gross income of participants under section 106; and

- (3) Payments made from the Trust are excludable from the gross income of participants, their spouses and dependents under section 105(b).

Issue One

Section 115(1) provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions was excludable from gross income for federal income tax purposes under section 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

Rev. Rul. 90-74, 1990-2 C.B. 34, determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under section 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

The Trust provides medical benefits to retired employees of the participating employers of the Plan, all of which are political subdivisions of a state or entities the income of which is excluded from gross income under section 115(1). Providing medical benefits to current and former employees as described above constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, the Trust performs an essential governmental function within the meaning of section 115(1).

The income of the Trust accrues to the participating employers of Plan, all of which are or will be political subdivisions of State or entities the income of which is excluded from gross income under section 115(1). No private interests participate in or benefit from the operation of the Trust. The benefit to the participating retirees is incidental to the public benefit. See Rev. Rul. 90-74.

Issue Two

Section 61(a)(1) provides that, except as otherwise provided, gross income includes all income from whatever source derived, including compensation for services.

Section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1(a) of the Income Tax Regulations provides 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 him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees.

Rev. Rul. 62-199, 1962-2 C.B. 32, states that the exclusion under section 106 is applicable to amounts paid for the benefit of retired employees as well as current employees.

Issue Three

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

Section 105(b) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in section 105(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 and dependents (as defined in section 152).

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

(1) The income of the Trust is excludable from gross income under section 115(1).

(2) Employer contributions paid to the Trust which are used exclusively to pay for the accident or health coverage of participants, their spouses and dependents are excludable from the participants' gross income under section 106.

(3) Payments made from the Trust are excludable from the gross income of participants, their spouses and dependents under section 105(b).

No opinion is expressed concerning the Federal tax consequences of the Trust under any other provision of the Code other than those specifically stated therein. In particular, no opinion is expressed concerning the Federal tax consequences if individual retiree reimbursement accounts for participants are established. In addition, no opinion is expressed as to the qualified status of the System or of the status of any account established pursuant to section 401(h) of the Code.

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.

Sincerely,

Harry Beker
Branch Chief, Health and Welfare (Employee
Benefits)
(Tax Exempt & Government Entities)