DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **200727017**
Release Date: 7/6/2007

234313/SE:TE:EO:RA:T2

April 10, 2007

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Identification Number:

Telephone Number:

EIN:

UIL: 111.00-00; 419.00-00; 409.03-00; 501.09-00; 509.09-02; 509.09-03; 4976.00-00

LEGEND:

A =
m =
x =

FACTS:

This is in response to a ruling request dated November 26, 2003, submitted on the Taxpayer's behalf, concerning the federal income tax treatment of a proposed transaction. The Taxpayer is an employee benefits trust exempt under Section 501(c)(9) ("Trust"). The Trust has requested rulings on the tax benefit rule, section 4976, and tax-exempt status under section 501(c)(9).

Trust was established in 1985 to provide funding for certain welfare benefits for the active employees of A. These active employee benefits included medical benefits under A's self-funded Medical Plan. As of January 1, 1993, the Trust was amended and restated to include funding for retiree medical and life insurance benefits for employees. From 1993 through 1998, A made contributions to the Trust totaling approximately $ to fund the retiree benefits, of which $ was deducted on A's federal income tax returns. Effective October 1, 1997, A converted its self-funded Medical Plan to an insured Medical Plan. No additional contributions were made to the Trust by A after 1998. After October 1, 1997, benefits paid by the Trust on behalf of retirees consisted of only retiree medical insurance premiums. During the period from 1993 to 2002, retiree contributions to the Trust totaled approximately $.

During the period from 1993 to 2002, the Trust made benefit payments and paid administrative expenses on behalf of retirees in the amount of $. During that time period, the Trust paid unrelated business income tax in the amount of approximately $. As of October 31, 2003, the value of the Trust was approximately $.

A has decided to terminate the portion of the Medical Plan relating to retiree medical insurance coverage. Effective at a future date, A's subsidy of the retiree medical insurance premiums will be reduced from 50 percent to 25 percent. Effective at a later date, the subsidy will be eliminated. Thereafter, no portion of the premiums for retiree medical insurance will be paid through the Trust. The full amount will be paid by the retirees, direct or indirectly, to the insurance company.

A would like to amend the Trust to reflect termination of the Medical Plan, as described above. Both before and after the amendment, funds in the Trust for which no deduction has been taken would only be used to provide benefits that are permissible under Code section 501(c)(9) to the active employees of A and its subsidiaries. The allocation of Trust earnings between deducted and nondeducted amounts will be performed on a year by year basis. The Trust has represented that all deductions allowable under sections 419 and 419A were taken.

RULINGS REQUESTED:

1. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide section 501(c)(9) benefits to active employees of A and its subsidiaries will not cause A to recognize taxable income under the tax benefit rule.

2. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide section 501(c)(9) benefits to active employees of A and its subsidiaries will not cause A to incur excise tax under Section 4976.

3. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide section 501(c)(9) benefits to active employees of A and its subsidiaries will not adversely affect its tax-exempt status under section 501(c)(9).

LAW AND ANALYSIS:

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

Code Section 111(a) 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.

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified at section 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc. 460 U.S. 370, 377 (1983). Its purpose is to approximate the results produced by a tax system based on transactional rather than annual accounting. Id. at 381. The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. Id. at 381-83. One must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions. Id. at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See American Mutual Life Insurance Co. v. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

Sections 419 and 419A limit the deductibility of employer contributions to a welfare benefit fund. Under section 419, the employer's deduction for contributions to a welfare benefit fund for a taxable year is generally limited to an amount necessary to provide benefits for that year (qualified direct cost), plus an addition to a qualified asset account, up to an account limit as set forth in section 419A, minus the fund's after-tax income. A fund's qualified asset account consists of any assets set aside to provide for the payment of (1) disability benefits, (2) medical benefits, (3) supplemental unemployment compensation benefits or severance pay benefits, or (4) life insurance benefits.

Under section 419A(c)(1), the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year), and administrative costs with respect to those claims.

Section 419A(c)(2) provides that the account limit for any taxable year may also include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary for (A) post-retirement medical benefits to be provided to covered employees or (B) post-retirement life insurance benefits to be provided to covered employees.

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) of the Code.

Contributions to a welfare benefit fund are deductible when paid, but only if they are otherwise deductible and only to the extent allowable under sections 419 and 419A. 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 apply to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985. Prior to that date deductions for contributions paid to a welfare benefit fund were governed by section 162. See section 1.162-10 and 1.162-10T of the Income Tax Regulations.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c).

Section 501(c)(9) of the Code describes a voluntary employees' beneficiary association ("VEBA") providing for the payment of life, sick, accident or other benefits to its members or their dependents or designated beneficiaries, and in which no part of its net earning inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-3(c) of the Income Tax Regulations provides the payment of medical insurance premiums for active employees is a permissible benefit.

Section 1.501(c)(9)-4(a) of the Income Tax Regulations provides that no part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of permissible benefits. Whether prohibited inurement has occurred is a question to be determined with regard to all the facts and circumstances.

Section 1.501(c)(9)-4(d) of the Income Tax Regulations provides that private inurement will not occur if any assets remaining in the VEBA, after the satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits permitted under a VEBA. The benefits must not be discriminatory in favor of officers, shareholders or highly compensated employees.

Section 4976 of the Code imposes an excise tax on an employer equal to 100 percent of any disqualified benefit provided by an employer-maintained welfare benefit fund.

Section 4976(b)(1)(C) of the Code defines "disqualified benefit" to include 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.

With respect to Ruling Request #1, A represents that the assets to be used to provide benefits to active employees of A and its subsidiaries are funds for which no deduction has been taken under sections 419A. Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. In this case, the transfer of amounts attributable to contributions (including earnings) that were not deductible under section 419 is not inconsistent with any deductions taken in prior years under section 419. Accordingly, there is no tax benefit and the application of the tax benefit rule will not result in gross income to A.

With respect to Ruling Request #2, A has requested a ruling that termination of its Medical Plan and its proposed use of assets for which no deduction has been taken to provide benefits to active employees will not constitute a “disqualified benefit” providing an impermissible reversion of assets. A was established to provide retiree medical and life insurance benefits and is a welfare benefit fund within the meaning of section 419(e). A is a welfare benefit fund as defined in section 419(e) because it is described in section 501(c)(9) of the Code and provides welfare benefits to employees of Taxpayer. Consequently, the deductibility of any contributions made to A after the effective date of section 419 is governed by section 419 of the Code, and any reversion to the benefit of the Taxpayer of any portion of A attributable to those contributions is subject to the excise tax under section 4976. In this case, only amounts attributable to contributions to A 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 will be applied to other benefits. Accordingly, there is no “disqualified benefit” within the meaning of section 4976 of the Code.

With respect to Ruling Request #3, A represents that the Trust will continue to provide permissible benefits, i.e, the payment of medical insurance premiums for active employees. Accordingly, the proposed amendment to the Trust and the proposed use of Trust assets will not result in prohibited inurement or otherwise affect the exempt status of Trust under section 501(c)(9).

RULINGS:

1. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide Section 501(c)(9) benefits to active employees of

A and its subsidiaries will not cause A to recognize taxable income under the tax benefit rule.

2. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide Section 501(c)(9) benefits to active employees of A and its subsidiaries will not cause A to incur excise tax under Section 4976.

3. The proposed amendment to the Trust and the use of Trust assets attributable to nondeductible contributions to provide Section 501(c)(9) benefits to active employees of A and its subsidiaries will not adversely affect its tax-exempt status under Section 501(c)(9).

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Please keep a copy of this ruling in your organization's permanent records.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Debra J. Kawecki
Manager, Exempt Organizations
Technical Group 2

Enclosure: Notice 437