

**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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**LEGEND**

District =

State =

County =

City =

Act =

Trust =

Plan =

Board =

This is in reply to your letter dated December 17, 2007, and subsequent correspondence, requesting various rulings on behalf of Trust.

## FACTS

District is a unit of local government and a body corporate of State organized and existing under Act. District is responsible for preventing pollution of City's source of water supply and treating wastewater to improve water quality in waterways within its jurisdiction.

District is governed by Board, comprised of nine members who are elected at large and serve on a salaried basis. District's day to day operations are managed by a General Superintendent, who is appointed by and reports directly to Board.

Act provides that Board may establish one or more trusts to provide funding and payment of health and other fringe benefits for retired, disabled, or terminated employees of District. District has established Trust to fund benefits under Plan, which provides for post-retirement health benefits covering eligible retirees, their spouses and dependents (as defined by §152 of the Internal Revenue Code (Code)). Trust is funded by contributions from District made according to a contribution plan. District is sole participating employer in Plan. Trust's expenditures will be made solely to pay retiree health benefits and Trust administration expenses. The Trust Agreement may be amended at any time by a vote of Board and District reserves the right to terminate Trust at any time. Upon termination of Trust, any assets remaining after satisfying Plan obligations shall revert to District.

District represents that Plan provides as follows: Plan is currently self insured and provides two options from which retirees may choose their coverage. District's contribution to Trust to fund benefits is based on aggregate plan costs, not an individual retiree basis. Participants and their spouses and eligible dependents receive the benefits as provided under the coverage chosen by the retiree. Plan does not allow for the cash-out of unused benefits, nor may retirees convert unused sick or vacation days to pay for benefits.

District further represents that no salary reduction contributions are made by Plan participants to the Trust to fund the benefits of the Plan.

## LAW AND ANALYSIS

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

Under Rev. Rul. 77-261, 1977-2 C.B. 45, the 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 political subdivisions, was excludable from gross income for federal income tax purposes under § 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 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 properly to conduct. In addition, pursuant to § 6012(a)(2) of the Code 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.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service 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 § 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.

Trust provides health benefits to eligible retired District employees and their spouses and dependents. Providing health benefits to current and former employees constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of §115(1) of the Code.

The income of Trust accrues to the benefit of District. District is the sole participating employer in Plan. Trust's assets will be used only for administrative expenses and expenditures in providing health care benefits to eligible Plan participants. No private interests participate in or benefit from the operation of Trust. Any distribution of remaining funds in Trust to satisfy Plan obligations upon the dissolution of Trust satisfies an obligation District has assumed with respect to providing health benefits to its employees. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

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

Section 106(a) of the Code 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 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 § 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 § 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, § 106 applies only to the portion of the contributions allocable to accident or health benefits.

Coverage provided under an accident and health plan to former employees and their spouses and dependents is excludable from gross income under § 106. See Rev. Rul. 62-199, 1962-2 C.B. 32; Rev. Rul. 82-196, 1982-2 C.B. 53.

Section 105(a) of the Code provides that, except as otherwise provided in § 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) of the Code provides an exception to § 105(a). Section 105(b) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 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 him for the medical care (as defined in § 213(d)) of the taxpayer, his spouse, and his dependents (as defined in § 152 of the Code).

Section 3121(a)(2) excludes from the definition of “wages” the amount of any payment made to, or on behalf of, an employee or any of his dependents under a plan established by an employer which makes provision for his employees on account of medical or hospitalization expenses in connection with sickness or accident disability.

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

(1) The income of Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of

§ 115(1) of the Code. Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

(2) Contributions paid to Trust and payments made from Trust which are used exclusively to pay for the accident or health coverage of eligible retired employees, their spouses and dependents (as defined in § 152) are excludable from the gross income of retired employees and their spouses and dependents under §§ 106 and 105(b) of the Code and do not constitute "wages" under § 3121(a)(2).

No opinion is expressed concerning the Federal tax consequences of Plan or Trust under any other provision of the Code other than those specifically stated herein. In particular, § 3.01(9) of Rev. Proc. 2007-3, 2007-1 I.R.B. 108 provides that the Service will not issue a ruling concerning whether a self-insured medical reimbursement plan satisfies the requirements of § 105(h) of the Code for a plan year. Accordingly, no opinion is expressed concerning whether Plans satisfy the nondiscrimination requirements of § 105(h) of the Code and § 1.105-11 of the regulations.

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 Branch  
Office of Division Counsel/Associate Chief  
Counsel (Tax Exempt and Government Entities)