

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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May 22, 2009

LEGEND

- District =
- State =
- Plan =
- Trust =
- Bank =

Dear :

This is in reply to your letter dated January 23, 2009, requesting rulings that the income of Trust is excluded from gross income under § 115(1) that contributions to Trust and payments from Trust to provide health benefits are excludable from gross income of the participants and their dependents under §§ 105 and 106 of the Internal Revenue Code.

FACTS

District, a political subdivision of State, adopted Plan to provide post-employment health and welfare benefits for its employees. District was created pursuant to enabling legislation passed by the State legislature (Act) to construct and operate water treatment plants and collection systems. It is governed by a commission comprised of eight members appointed by the governor of State. Each commission member serves a four year term and may be suspended or removed by the governor at his pleasure.

District has been delegated the power of eminent domain. Pursuant to Act, District's sole source of revenue is from fees collected from users of its water treatment services.

Under Plan, District pays a portion of the premium for health insurance coverage for eligible retirees. Participants are responsible for the remainder of the premium. All participant contributions to Plan are made on a post-tax basis. Only eligible retirees and their participating dependents may participate in Plan.

District created Trust to provide a mechanism for funding benefits under Plan. Trust's income is derived from contributions from District and participating retirees and from investment income. Trust assets are used solely for payment of medical benefits on behalf of eligible retirees, spouses and participating dependents and for Trust administration. No portion of the principal or income of Trust may be used for any other purpose than the exclusive benefit of participants in Plan and the payment of reasonable Plan and Trust expenses.

The original trustee of Trust is Bank. The trustee is appointed by District. District may remove the trustee and appoint a successor trustee at any time. District is the trust administrator. District may terminate Trust at any time. Upon termination of Trust, any assets remaining in Trust will be used solely to provide benefits under Plan and satisfy any remaining liabilities. If any residual assets remain after satisfaction of all liabilities of Plan, such residual assets will be returned to District.

Law & Analysis

Section 115

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 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 § 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 utility 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 § 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.

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 retired employees of District, a political subdivision of State. Providing health benefits to current and retired government 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 District. Upon the dissolution of Trust the use of its remaining funds to provide health benefits for retirees 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.

Based on the information and representations submitted by Trust, we hold that 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). Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

Sections 105 and 106

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

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) 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) 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) of the taxpayer, his spouse, and his dependents (as defined in § 152 of the Code).

Based on the information submitted and representations made, we conclude that contributions paid to Plan and payments made from Plan which are used exclusively to pay for the accident or health coverage of retired employees and their spouses and dependents (as defined in § 152 of the Code) are excludable from the gross income of retired employees and retired employees' spouses and dependents under §§ 106 and 105(b) of the Code.

No opinion is expressed concerning the Federal tax consequences of Trust or Plan under any other provision of the Code other than those specifically stated herein.

The ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

In accordance with a Power of Attorney on file, we are sending a copy of this letter to your representative.

Sincerely,

Sylvia F. Hunt
Assistant Chief, Exempt Organizations
Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:

Copy of this letter
Copy for § 6110 purposes

CC: