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Department of the Treasury  
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Legend:

County =

State =

Plan =

Trust =

Dear :

FACTS

County is a political subdivision of State. According to the information provided, County adopted Plan to provide medical benefits for eligible employee, retirees and their spouses and dependents (as defined in §152 of the Internal Revenue Code (Code)). Additionally, County provides medical benefits to a group of former employees who continue to participate in County's pension plan. All medical benefits are insured benefits.

Retirees may elect to continue the health plan if they are eligible for normal or early retirement and pay a premium. As represented, an eligible retiree is a retiree who (1) has attained age 50; (2) has completed at least 10 years of continuous service with County or has reached age 65 with at least 5 years of County service; and (3) has their share of Plan premiums paid by authorized after-tax deductions from monthly retirement check. Thus, Plan benefits for eligible retirees are funded by a combination of retiree post-tax contributions and County contributions. Benefit levels are determined by County through annual appropriations.

County represents that there are no cash-outs of unused amounts from Plan; there is no conversion of sick or vacation days into retiree health benefits; and there is no salary reduction to fund retiree health benefits.

County created Trust to provide a vehicle for funding post-employment benefits under Plan. The Trust agreement allows the employees of County and certain government bodies affiliated with County to participate in Trust. Trust income is derived from County contributions, employee contributions and investment income. County will amend the Trust agreement to provide: (1) in no case may an entity become a participating employer in Trust unless it is a state, a political subdivision of a state or an entity the income of which is excluded from gross income under §115(1) of the Code; and (2) Trust income is used exclusively to provide benefits to retirees, their spouses and dependents and to pay administrative costs.

Trust is governed by County retirement plan board which has nine members. Three members are County employees who serve by virtue of their position. One member is a County Commissioner, selected by the Chairman of County Commissioners. One member is a member of the general public, selected by the County Commissioners. Two members are County employees, selected by a majority of County employees. Two members are retired county employees, selected by a majority of retired County employees.

County's governing board has exclusive authority to amend the Trust agreement and to terminate Trust. Upon termination, Trust assets are used to pay benefits and administrative expenses and any remaining assets will be distributed to County. County proposes to amend Trust to provide that upon termination of Trust, in no case will any remaining assets be distributed to an entity that is not a state, a political subdivision of a state or an entity the income of which is excluded from gross income under §115(1) of the Code.

## 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 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 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) 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 County, a political subdivision of State. 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 County. No private interests participate in or benefit from the operation of Trust. Any distribution of remaining funds in Trust to participating retirees upon the dissolution of Trust satisfies an obligation County has assumed with respect to providing benefits to their employees. The benefit to participants 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.

However, § 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(d)) 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 as follows:

(1) Provided the amendments to the Trust agreement as described above are adopted and, as of the date the amendments are adopted, the income of Trust will be 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 will be excludable from gross income under § 115(1) of the Code.

(2) If Trust is classified as a trust for federal income tax purposes, Trust is not required to file an annual income tax return under § 6012(a)(4) of the Code.

(3) Contributions paid to Plan and payments made from Plan which are used exclusively to pay for the accident or health coverage of retired employees, their spouses and dependents (as defined in § 152) 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 Plan or Trust under any other provision of the Code other than those specifically stated herein.

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