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LEGEND

City =

State =

Trust =

Plans =

Dear :

FACTS

City is a municipality and political subdivision of State, with the authority to lay and assess property and other taxes, as well as to conduct governmental functions, such as those dealing with zoning and public health and safety. It is governed by a mayor and eight aldermen, who are elected by City residents. A fulltime city administrator, under the direction of the mayor and board of aldermen, is responsible for the day-to-day operations and management of City's professional staff.

City sponsors health benefits plans providing comprehensive coverage for City employees, retirees, and their eligible dependents. Employees who retire directly from City service may continue coverage on a contributory basis under one of two post-retirement medical plans (the "Plans"). Retirees under the age of 65 are covered through a self-insured plan similar to the one for current employees. For retirees who have reached age 65 or are eligible for Medicare, City offers a Medicare Supplemental Plan underwritten by a health insurance company. Retirees contribute to Plans on an

after-tax basis. Under Plans, a retiree's contribution to the cost of the plan is based on length of service, with retirees having more years of service paying a smaller percentage of plan costs.

City does not provide benefits under Plans to individuals who do not qualify as a retiree's spouse or dependent under §152 of the Internal Revenue Code (the Code). Retired employees may not make pre-tax contributions to pay for medical benefits. Neither active employees nor retirees have the option to cash out amounts in Plans (i.e., eligible retirees may not receive cash or other taxable benefits in lieu of post-retirement medical benefits). Plans do not permit conversion of sick or vacation benefits to retiree medical benefits. All retiree medical benefits terminate upon the death of the retired employee and any dependents.

City established Trust to pay for medical expenses of its former employees and dependents. The trustee is a private trust company unrelated to City. Trust assets are to be used exclusively to provide post-retirement health benefits under Plans. Trust assets which come from City and participant contributions may be used to pay for Plans and Trust operations. Trust assets may not be used to pay for life insurance or other non-health benefits. City maintains the authority to determine all benefit payments, appoint investment managers, and take all actions necessary to administer Trust and Plans. Trust assets are to be managed by City or by an independent investment manager designated by City. The Trust agreement may be amended at any time, except that no amendment may authorize any part of Trust corpus or income to be used for or diverted to, purposes other than the exclusive benefit of Plans' participants or the payment of Trust expenses. Trust is irrevocable. However, if all liabilities owed to Plans' participants are satisfied, or if Plans and Plans' benefits have been terminated and there is any balance remaining, it must be applied for the exclusive benefit of Plans' participants to provide post-retirement medical benefits.

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 an essential governmental function and accruing to a state or a political subdivision of a state.

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 stated 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. The ruling concluded that because the participating political subdivisions have an unrestricted right to receive in their own right their proportionate share of the investment fund's income as it is earned, the fund's income accrues to them within the meaning of § 115(1).

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 arising from their obligations regarding public liability, workers' compensation, or employees' health is excludable from gross income under § 115. In this ruling, private interests did not materially participate in the organization, nor did they benefit more than incidentally from the organization.

Trust was established as a separate entity by ordinance, pursuant to the exercise of City's legislative power. By payment of medical expenses and health insurance premiums, Trust provides health benefits to retirees and their eligible dependents. Providing such benefits to former public employees constitutes the performance of an essential governmental function within the meaning of § 115(1). See Rev. Rul. 90-74 and Rev. Rul. 77-261.

The provision of health benefits to participating retirees and their dependents satisfies a City obligation to provide those benefits; thus, the income of the Trust accrues to the benefit of the City, which is an instrumentality of the State. No private interests participate in, or benefit from, the operation of Trust, other than as providers of goods and services. The benefit to retired City 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.

However, 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(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) The income of Trust is derived from the exercise of an essential governmental function and will accrue to the political subdivision of a state for purposes of § 115(1). Consequently, we rule that Trust's income is excludable from gross income under § 115(1) of the Code.

(2) Contributions paid to Plans and payments made from Plans which are used exclusively to pay for the accident or health coverage of retired employees, 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 as to the classification of Trust as a trust for Federal tax purposes. Further, no opinion is expressed concerning the Federal tax consequences of Plans or Trust under any other provision of the Code other than those specifically stated herein. In particular, § 3.01(10) of Rev. Proc. 2009-1, 2009-1 I.R.B. 107, provides that the Service will not issue a ruling concerning whether a self-insured medical reimbursement plan satisfies the requirements of §105(h) 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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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