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Date:
October 01, 2009

Legend

Taxpayer =

State =

County =

Trust =

Plan =

Dear :

This is in reply to your letter dated June 2, 2009 and subsequent correspondence in which you request various rulings on behalf of Taxpayer with respect to Plan and Trust.

FACTS

Taxpayer is a special purpose district organized and existing under the laws of State. Taxpayer is organized to operate a waterworks and sewer system for County and

various municipalities within County. As a body corporate and politic of State, Taxpayer is a political subdivision of State.

Taxpayer established the Plan and adopted Trust to provide health and dental benefits to its eligible retirees and their spouses. Taxpayer is the sole employer participating in Plan. Taxpayer is authorized to amend or terminate Plan.

Plan currently provides all benefits through insurance contracts. Eligibility under Plan is based on hire date, years of service with Taxpayer upon retirement and Medicare eligibility. Benefits under Plan are offered only to retired employees of Taxpayer and their spouses. The Taxpayer's liability for the cost of benefits for retirees depends on the retiree's years of service with Taxpayer. A retiree is required to pay for spousal coverage.

Taxpayer represents that there are no pre-tax salary reduction elections under Plan. In addition, Taxpayer represents that Plan does not permit a cash-out of unused amounts or conversion of sick or vacation days to retiree health benefits. Taxpayer does not provide benefits to individuals who do not qualify as a retiree or spouse.

Taxpayer created Trust as a vehicle for funding retiree health benefits under Plan. Currently, Trust assets consist of contributions made by Taxpayer and investment income. Trust assets are to be used exclusively for benefits under Plan and for all reasonable and necessary expenses of administering Trust. Private interests do not participate in Trust. No part of Trust may be diverted to purposes other than the exclusive benefit of the participants and their beneficiaries.

Taxpayer will have exclusive authority and discretion to manage and control the assets of Trust, but will delegate investment management of Trust's assets to the trustee pursuant to the terms of the Trust Agreement.

Trust provides that Taxpayer may amend Trust at any time. Taxpayer may terminate Trust only upon the payment of all Trust obligations and expenses. Any remaining Trust assets may be distributed in accordance with the direction of Taxpayer. Taxpayer will amend Trust Agreement to provide that in no case will 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 of the Internal Revenue Code (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 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 Taxpayer, 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 Taxpayer. Taxpayer is the sole participating employer in Plan. 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 the Taxpayer has assumed with respect to providing health benefits to its retirees. The benefit to the participating retirees 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 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 for 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 as follows:

- (1) As of the effective date of the proposed amendment to Trust as described above, Trust income will be derived from the exercise of an essential governmental function and will accrue to a state or 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) 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 are excludable from the gross income of retired employees and spouses 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. No opinion is expressed as to the classification of Trust as a trust for federal tax purposes.

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