

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200802003**

Release Date: 1/11/2008

Index Number: 106.00-00, 115.00-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:TEGE:EB:HW
PLR-114674-07

Date:
October 02, 2007

LEGEND

Taxpayer =

State =

Trust =

Plan =

Dear :

This is in reply to the your letter dated February 28, 2007, and subsequent correspondence requesting rulings on behalf of Taxpayer concerning the Plan and the Trust.

FACTS

Taxpayer is a municipality organized and existing under the laws of State. As a municipality, Taxpayer is a political subdivision of State. Taxpayer adopted Plan to provide post-retirement medical benefits for its employees. Only Taxpayer's full-time

employees, their spouses and eligible dependents (as defined in section 152 of the Internal Revenue Code (the "Code")) may participate in Plan. Plan covers all full-time employees, including collectively bargained employees.

Only mandatory employer contributions, mandatory employee contributions, and mandatory contributions of accumulated leave are made to Plan. The Plan provides that "mandatory employee contributions (i.e. mandatory salary reduction contributions and mandatory contributions of accumulated sick leave, vacation, and severance) which are not actually or constructively received by the Participant will be considered Employer Contributions for purposes of the Plan." The Plan also provides that "no contributions other than Employer Contributions are required nor will they be accepted." Contributions are made during an employee's active employment with Taxpayer.

Under Plan, each employee has a separate health account to be used after retirement. Distributions from the retired employee's health account can only be used for health insurance or medical care expenses incurred after retirement. Specifically, distributions can be used only for medical expenses as defined in section 213(d) of the Code. Any balance remaining in the account after the death of the retiree and his or her spouse and dependents must be forfeited. At that point, the account will be closed and any remaining funds will become general assets of the Plan. Even on death, the balance in the account may be spent only on permissible healthcare expenses for the decedent's surviving spouse or dependents. The balance in the account can never be conveyed to anyone else.

Taxpayer represents that there is no individual employee election in the Plan. There is no election as to whether or not to participate and no election on the level of mandatory employer contributions, mandatory employee contributions, or mandatory leave settlement. Participation is mandatory for all employees in a bargaining unit that negotiates to participate in Plan.

Taxpayer established Trust to fund Plan benefits. The trustee is appointed by Taxpayer, and can be removed by Taxpayer at any time. In the event of the trustee's removal or resignation, a successor trustee will be appointed by Taxpayer.

Contributions to Plan are deposited in Trust and invested among the investments selected by Taxpayer. Trust's income is derived from Plan contributions and investment income. Trust assets are held for the exclusive purposes of providing benefits to participants of Plan and their beneficiaries and defraying the reasonable expenses of administering Plan and Trust. The Trust Agreement provides that no portion of the corpus or income of Trust will revert to Taxpayer and that no private interests participate in or benefit from the operation of Trust other than as providers of goods or services.

Taxpayer proposes to amend the Trust Agreement to provide that Taxpayer may amend the Trust Agreement or terminate the Trust at any time. In addition, the Trust

Agreement will be amended to provide that upon the termination of Trust, in no case will Trust's 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 section 115 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 section 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 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 section 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 section 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, their spouses and eligible dependents. Taxpayer is the sole participating employer in Plan and is a political subdivision of a state. Providing health benefits to former employees of a political subdivision, as well as to their spouses and dependents, 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 section 115(1) of the Code.

The income of Trust accrues to Taxpayer, a political subdivision and the sole participating employer in Plan. The distribution of funds in Trust to participating retirees

satisfies an obligation Taxpayer has assumed with respect to providing health benefits to its employees. Any benefit to the insurance companies, health care providers or to the participating retirees, their spouses and dependents is incidental to the public benefit. No private interests participate in or benefit from the operation of Trust other than as providers of goods and services. See Rev. Rul. 90-74.

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 by section 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 section 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, section 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 section 106. See Rev. Rul. 62-199, 1962-2 C.B. 32; Rev. Rul. 82-196, 1982-2 C.B. 53.

Based on the information and representations submitted by Trust, and provided the amendments to the Trust Agreement described above are adopted, we hold that, as of the date the amendments are adopted, 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 section 115(1). Accordingly, Trust's income is excludable from gross income under section 115(1) of the Code.

We also conclude that mandatory contributions made to Plan on behalf of active employees to provide for the health coverage after retirement, their spouses and dependents (as defined in section 152) are excludable from gross income under section 106 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. In particular, Section 3.01 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 section 105(h) for a plan year. Accordingly, no opinion is expressed concerning whether Plan satisfies the nondiscrimination requirements of section 105(h) or Treas. Reg. §1.105-11.

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 and Government Entities)