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Department of the Treasury
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CC:TEGE:EB:HW
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Date:
May 31, 2007

Legend

Taxpayer =

Trust =

Plan =

City =

State =

Board =

Dear :

This is in reply to your letter dated October 23, 2006, and subsequent correspondence, in which you request various rulings on behalf of Taxpayer with respect to Plan and Trust.

FACTS

City is a municipality organized and existing under the laws of State, and governed by Taxpayer. As a municipality, City is a political subdivision of State.

City adopted Plan as a means of providing health and welfare benefits to its retiree employees, their spouses, dependents, domestic partners, and others. Participating employers include public agencies governed and managed by City. City will amend Plan to require that all participating employers be states, political subdivisions of states, or entities the income of which is excluded from gross income under § 115 of the Internal Revenue Code (the Code). Plan is administered by City and may be amended or terminated by City.

Plan provides benefits through both insurance and self-insured arrangements. Under Plan, City pays a portion of the premium for health insurance coverage for eligible retirees. Participants are responsible for the remainder of the premium.

City will amend Plan to provide that City will take reasonable steps to identify individuals who do not qualify as dependents under § 152 of the Code. City will include in taxable income of participants imputed income relating to the participation in Plan of domestic partners and other persons who are not dependents under § 152 of the Code.

City will amend Plan to provide that in no event will contributions be made on a pre-tax basis. City states that to the extent Plan constitutes a self-insured medical reimbursement plan, Plan conforms to the nondiscrimination requirements of § 105(h) and the regulations thereunder.

Trust was created by City to provide a vehicle for funding benefits under Plan. The income of Trust consists of contributions from City and investment income. In some cases, contributions are also received from participating retirees. Trust's expenditures are used solely to pay retiree benefits and trust administration expenses. Trust was created pursuant to a Trust Agreement. The Trust Agreement provides that the City Director of Finance shall be the trustee of Trust. The Trust Agreement may be amended at any time by vote of the Board, a department of City. City reserves the right to terminate Trust at any time for any reason by resolution of Board. Upon termination, the assets of Trust shall be transferred to one or more trust funds provided such trust funds are for the purpose of providing health and welfare benefits to the participants of Plan. City will amend the Trust Agreement to provide that in no case shall Trust's assets be distributed upon termination 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 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 public agencies of City, all of which are political subdivisions 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 City and its agencies. City and its agencies are the sole participating employers 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 City and its agencies have 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 6012(a)(2) provides, in general, that every corporation subject to taxation under subtitle A shall make returns with respect to income taxes under subtitle A. In addition, § 1.6012-2(a)(1) of the Income Tax Regulations provides in part that every corporation,

as defined in § 7701(a)(3), subject to taxation under subtitle A of the Code shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income.

Section 6012(a)(4) provides, in general, that every trust having for a taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income, shall make returns with respect to income taxes under subtitle A. Section 7701(a) and § 301.7701-4 of the regulations define trusts for purposes of § 6012.

Section 61(a)(1) of the Code and § 1.61-21(a)(3) of the 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 1.61-21(a)(3) of the regulations provides that a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for such services.

Section 1.61-21(a)(4) of the regulations provides that, in general, a taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. If a fringe benefit is furnished to someone other than the service provider, such benefit is considered as furnished to the service provider, and use by the other person is considered use by the service provider.

Section 1.61-21(b)(1) of the regulations provides that an employee must include in gross income the fair market value of the fringe benefit. In general, fair market value, under the principles set forth in § 1.61-21(b)(2) of the regulations, is determined on the basis of the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. In the case of group medical coverage, the amount includible in the individual's gross income is the fair market value of the group medical coverage.

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 104(a)(3) 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 received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not included in the gross income of the employee, or (B) are paid by the employer).

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).

Employer-provided coverage under an accident or health plan for personal injuries or sickness incurred by individuals other than the employee, his or her spouse, or his or her dependents (as defined in § 152), is not excludable from the employee's gross income under § 106. In addition, reimbursements received by the employee through an employer-provided accident and health plan are not excludable from the employee's gross income under § 105(b) unless the reimbursements are for medical expenses incurred by the employee, his or her spouse, or his or her dependents, as defined in § 152. However, reimbursements that are not excludable under § 105(b) may be excludable under § 104(a)(3) if they are attributable to employer contributions that were included in the employee's income.

Based on the information submitted and representations made, and provided the amendments to Plan and Trust Agreement as described above are adopted, we conclude as follows:

(1) 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.

(2) If Trust is classified as a trust for federal income tax purposes, no annual income tax return must be filed by Trust pursuant to § 6012(a)(4) because any income realized by Trust is excluded from gross income under § 115(1). However, if Trust is a corporation, as defined in § 7701(a)(3), it will be required to file an income tax return pursuant to § 6012(a)(2).

(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.

(4) With respect to domestic partners (and others) who do not qualify as § 152 dependents, neither the retired employee nor the domestic partner will include in income any amount received as payment or reimbursement under Plan pursuant to the provisions of § 104(a)(3) of the Code to the extent the coverage was paid for with after-tax contributions or the fair market value of the coverage was included in the gross income of the participant.

(5) The medical coverage provided to domestic partners (and others) will not otherwise adversely affect the exclusions from gross income under §§ 106 or 105(b) of amounts contributed to or paid by Plan for the medical care of retired employees, their spouses, and dependents (as defined in § 152 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, § 3.01(9) 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 § 105(h) for a plan year. Accordingly, no opinion is expressed concerning whether Plan satisfies 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 representative.

Sincerely,

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

cc: