Internal Revenue Service

Number: **201625005**
Release Date: 6/17/2016

Index Number: 4976.01-00, 401.27-00, 4980.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

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Refer Reply To:
CC:TEGE:EB:HW
PLR-131579-15
Date: March 11, 2016

LEGEND:

Taxpayer =

State =

HRA Plan =

Health Plan =

Trust A =

Trust B =

Month Y =

Dear :

This responds to your letter of September 25, 2015, and subsequent correspondence, requesting a ruling regarding the tax consequences under sections 401(h), 4980 and 4976 of the Internal Revenue Code (Code) of the return of assets from section 401(h) accounts to Taxpayer and the transfer of assets from Trust A to Trust B.

FACTS

Taxpayer is a state public employees' retirement system that is an instrumentality of State. You represent that Taxpayer is exempt from Federal income tax under section 115. Taxpayer operates three retirement plans whose participants are retired public employees: a defined benefit plan (Plan A), a defined benefit plan with elements of a defined contribution plan (Plan B), and a defined contribution plan (Plan C). You represent that each of these retirement plans qualifies as a governmental plan pursuant to section 414(d) of the Code, and each of the plans meets the requirements of section 401(a) that apply to governmental plans.

Taxpayer provides retiree health benefits to eligible retirees in Plan A and Plan B through section 401(h) accounts, and beginning in Month Y, through Trust B, which you represent is a section 115 trust, the income of which is excludable from gross income under section 115(1) of the Code. Taxpayer also provides retiree health benefits to eligible retirees in Plan C under Health Plan through Trust A, which you represent is a voluntary employees' beneficiary association described in section 501(c)(9) of the Code (VEBA). Taxpayer is terminating its current health plans for retirees in Plan A and Plan B and creating a new pre-Medicare plan and a new post-Medicare health reimbursement arrangement. To fund the Health Plan, Plan A and Plan B will return the section 401(h) account assets to Taxpayer upon satisfying all medical benefit liabilities under Plan A and Plan B, and Taxpayer will transfer the amounts to Trust B. Taxpayer will also terminate Trust A and transfer Trust A's assets to Trust B. Following the transfer, Health Plan will be funded solely through Trust B. Neither Taxpayer nor any other contributing employer have ever taken an income tax deduction for any contributions to Trust A under section 419 or any other section of the Code.

When the section 401(h) accounts terminate, Taxpayer represents that the amounts credited to the section 401(h) accounts will revert back to Taxpayer, both in its capacity as a contributing employer and as an agent of the other contributing employers. Taxpayer will structure the reversions from each of the section 401(h) accounts as credits back to the contributing employers and will assess the employers a contribution due to Trust B in an equal amount. Taxpayer has provided a proposed rule change to State's administrative code granting Taxpayer authority to act on its own behalf and as the contributing employers' agent for purposes of terminating the section 401(h) accounts and contributing the reverted amounts to Trust B. Taxpayer also represents the proposed transactions will not take place until after the proposed rule change is adopted in the State's administrative code.

RULINGS REQUESTED

1. The return of the section 401(h) account assets to Taxpayer will not result in a failure of Plan A or Plan B to satisfy the requirements of section 401(h);

2. Taxpayer will not be subject to the excise tax under section 4980 as a result of the return of the section 401(h) account assets to the Taxpayer; and

3. The transfer of assets from Trust A to Trust B upon termination of Trust A will not result in a “disqualified benefit” within the meaning of section 4976(b)(1)(C), and will not, in and of itself, cause Taxpayer to be liable for excise tax under section 4976.

LAW

Section 401(a) of the Code describes requirements for a qualified trust that is created or organized in the United States and forms part of a pension plan of an employer that is for the exclusive benefit of the employer’s employees or their beneficiaries. Section 501(a) provides in pertinent part that an organization described in section 401(a) is generally exempt from income tax.

In pertinent part, section 401(h) provides that, under regulations prescribed by the Secretary, and subject to the provisions of section 420, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents, but only if –

(1) such benefits are subordinate to the retirement benefits provided by the plan,
(2) a separate account is established and maintained for such benefits,
(3) the employer’s contributions to such separate account are reasonable and ascertainable,
(4) it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits, and
(5) upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the plan, be returned to the employer.

Section 1.401-14(a) of the Income Tax Regulations provides that, under section 401(h), a qualified pension or annuity plan may make provision for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. The term “medical benefits described in section 401(h)” is used in this section to describe such payments.

Section 1.401-14(c)(5) of the Income Tax Regulations provides that, under section 401(h), a qualified pension or annuity plan must provide that any amounts which are contributed to fund medical benefits described in section 401(h) and which remain in the medical benefits account upon satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

Section 414(d) of the Code provides that a “governmental plan” means a plan established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

Section 4(b)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) provides that Title I of ERISA does not apply to governmental plans as defined in section 3(32) of ERISA. Section 3(32) of ERISA provides that a “governmental plan” means a plan established or maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing. [1]

Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund are not deductible under Chapter 1, but if they would otherwise be deductible, are (subject to the limitation of section 419(b)) deductible under section 419 for the taxable year in which paid.

Section 419(e)(1) defines “welfare benefit fund” as any fund which is part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries. Pursuant to section 419(e)(3), the term “fund” includes any organization described in section 501(c)(9) of the Code.

Section 4976(a) of the Code imposes a 100 percent excise tax if an employer maintains a welfare benefit fund and there is a disqualified benefit provided during any taxable year.

Section 4976(b)(1)(C) defines "disqualified benefit" to include any portion of a welfare benefit fund reverting to the benefit of the employer. Section 4976(b)(3) provides that section 4976(b)(1)(C) does not apply to any amount attributable to a contribution to the fund which is not allowable as a deduction under section 419 for the taxable year or any prior taxable year (and such contribution will not be included in any carryover under section 419(d)).

Section 4980(a) provides for a 20% excise tax on the amount of any employer reversion from a qualified plan. Section 4980(d) provides that section 4980(a) will be applied by substituting “50 percent” for “20 percent” with respect to any employer reversion from a qualified plan unless (A) the employer establishes or maintains a qualified replacement plan under section 4980(d)(2), or (B) the plan provides benefit increases meeting the requirements of section 4980(d)(3). Section 4980(c)(1)(B) provides that for purposes of section 4980, a “qualified plan” does not include a governmental plan (within the meaning of section 414(d) of the Code).

[1] Title I of ERISA is generally interpreted and administered by the U.S. Department of Labor. See ERISA section 505 and Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978).

ANALYSIS

Taxpayer has represented that when the section 401(h) accounts terminate, the amounts credited to the section 401(h) accounts will revert back to Taxpayer, both in its capacity as a contributing employer and as an agent of the other contributing employers (all of which are instrumentalities of State). Taxpayer further represents that it will structure the reversions from each of the section 401(h) accounts as credits back to the contributing employers and will assess the employers a contribution due to Trust B in an equal amount. Taxpayer has provided a proposed rule change to State's administrative code granting authority to Taxpayer to act on its own behalf and as the contributing employers' agent for purposes of terminating the section 401(h) accounts and contributing the reverted amounts to Trust B. Taxpayer also represents the proposed transactions will not take place until after such authority is granted. Based on these facts and representations, the return of the section 401(h) account assets to the Taxpayer will not violate section 401(h) and section 1.401-14 of the Income Tax Regulations.

The two section 401(h) accounts from which Taxpayer is receiving a reversion are part of Plan A and Plan B respectively, both of which are governmental plans within the meaning of section 414(d). Pursuant to section 4980(a)(1)(B), neither Plan A nor Plan B is a "qualified plan" with respect to which section 4980 applies. Accordingly, the excise tax under section 4980 does not apply to the reversion of the section 401(h) account assets to Taxpayer.

Since Taxpayer is a government instrumentality and is exempt from Federal income tax under section 115, Taxpayer's contributions to Trust A were not allowable as a deduction under section 419. Under section 4976(b)(3), section 4976(b)(1)(C) does not apply to any amount attributable to contributions to a fund that were not allowable as a deduction under section 419. Consequently, the transfer of Trust A's assets to Trust B upon Trust A's termination will not result in any "disqualified benefit" within the meaning of section 4976(b)(1)(C), and will not, in and of itself, cause Taxpayer to be liable for excise tax under section 4976.

RULINGS

1. The return of the section 401(h) account assets to Taxpayer will not result in a failure of Plan A or Plan B to satisfy the requirements of section 401(h).

2. Taxpayer will not be subject to excise tax under section 4980 as a result of the return of the section 401(h) account assets to the Taxpayer; and

3. The transfer of assets from Trust A to Trust B upon termination of Trust A will not result in a "disqualified benefit" within the meaning of section 4976(b)(1)(C), and will not, in and of itself, cause Taxpayer to be liable for excise tax under section 4976.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based on the assumption that Plan A and Plan B are qualified under section 401(a). These rulings are based upon information and representations submitted by Taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Specifically, it does not address the tax consequences of the transactions to participating employers or to Trust A or Trust B. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Janet A. Laufer
Senior Technician Reviewer
Health & Welfare Branch
Office of Associate Chief Counsel
(Tax Exempt & Government Entities)