

Internal Revenue Service

Department of the Treasury

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Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EB:HW

PLR-117187-16

Date:

September 28, 2016

Legend:

Taxpayer =

Trust =

Active Plan =

Retiree Plan =

Date 1 =

Date 2 =

Year 1 =

W =

X =

Y =

Z =

Dear _____ :

This responds to your letter dated May 24, 2016, and subsequent correspondence, requesting a ruling on the federal tax consequences under section 4976 and section 419 of the Internal Revenue Code (Code) with respect to the transfer of assets within Trust to a separate subaccount that will provide health benefits to current employees.

FACTS

Taxpayer is a holding company for subsidiaries that provide public utility services. Taxpayer uses the accrual method of accounting and the calendar year as its taxable year. The company maintaining Trust was acquired by Taxpayer as the result of a transaction on Date 1. Trust was established pursuant to a trust agreement entered into as of Date 2 and in the same year received a determination letter that it is a voluntary employees' beneficiary association under section 501(c)(9).

Taxpayer maintains Trust, which currently provides health and life insurance benefits under Retiree Plan to certain eligible union and nonunion retirees, and their eligible dependents, of Taxpayer and its subsidiaries. Taxpayer represents that Trust is not eligible for the exception to the deduction limits under section 419A(f)(5) of the Code because fewer than 90 percent of Trust's members are subject to a collective bargaining agreement.

Taxpayer represents that it has been determined that, as of December 31, 2015, the fair market value of the assets of Trust exceeds the present value of the benefit obligations of Retiree Plan in the amount of \$W.

Taxpayer will amend Trust to provide for a one-time transfer in 2017 of an amount held by Trust (Transferred Assets) to a separate subaccount held by Trust (Active Subaccount) and future use of Active Subaccount to provide health benefits under Active Plan to current employees for whom Taxpayer and its subsidiaries have no obligation to provide such benefits. Taxpayer represents that the amount of Transferred Assets will not be less than \$X or more than \$Y, but in no event more than the amount that the fair market value of the assets of Trust exceeds the present value of the benefit obligations of Retiree Plan on a measurement date in 2017 chosen by Taxpayer that occurs before the date of the one-time transfer in 2017.

While retirees are required to pay a portion of the costs of Retiree Plan, Taxpayer represents that, from Year 1 through 2015, disbursements under Retiree Plan have exceeded employee contributions to Retiree Plan on an annual basis. Taxpayer does not have records for years before Year 1, but it has no reason to believe that disbursements under Retiree Plan did not exceed employee contributions to Retiree Plan on an annual basis for those years.

Taxpayer represents that all employer contributions from Year 1 onwards have been deducted by Taxpayer on its Federal income tax returns. Taxpayer does not have records for years before Year 1, but it has no reason to believe that there were any nondeductible contributions to Trust for those years. Taxpayer made and deducted aggregate contributions to Trust from Year 1 onwards in the amount of at least \$Z. The amount of the aggregate deducted contributions exceeds the amount of Transferred Assets. Taxpayer does not expect to make or deduct any contributions to Trust in 2016 and before the one-time transfer in 2017.

Taxpayer represents that in the context of the one-time transfer to Active Subaccount and future use of Transferred Assets, Taxpayer will not divert or direct any portion of Trust's assets to Taxpayer. Taxpayer also represents that it will not use any of the assets in Active Subaccount for the purposes of providing health benefits to any employees of Taxpayer or any of its subsidiaries for whom Taxpayer and its subsidiaries have any current or future legal obligation to provide such benefits.

Taxpayer represents that the amendment of Trust and the one-time transfer of Transferred Assets to Active Subaccount will occur in 2017. Taxpayer further represents that Taxpayer will include the amount of Transferred Assets in gross income for 2017 and that no portion of that amount is excludable under the exclusionary part of the tax benefit rule.

RULINGS REQUESTED

Taxpayer requests rulings that:

- (1) The transfer of assets to Active Subaccount and future use of the assets for purposes of providing health benefits to current employees as described in the ruling application and subsequent submissions will not be treated as a disqualified benefit under section 4976(b)(1)(C) of the Code and will not, in and of itself, result in excise tax under section 4976 of the Code.
- (2) The amount of the assets transferred to Active Subaccount and included in Taxpayer's gross income in 2017 will be treated as a contribution in 2017 within the meaning of section 419(a) of the Code.

LAW

Section 61(a) of the Code provides that, unless otherwise excepted, gross income includes all income from whatever source derived.

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to

the extent the amount did not reduce the amount of tax imposed by Chapter 1 of the Code.

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983); see also Hughes & Luce, LLP v. Commissioner, 70 F.3d 16 (5th Cir. 1995), cert. denied, 517 U.S. 1208 (1996). The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. Frederick v. Commissioner, 101 T.C. 35, 40-41 (1993). The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is partially codified at section 111(a) and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted; the exclusionary part cannot apply unless the inclusionary part applies.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro National Bank, 460 U.S. at 377. The general purpose of the tax benefit rule is to approximate the results produced by a tax system based on transactional rather than annual accounting. Id. at 381. The tax benefit rule will "cancel out" an earlier deduction when a later event is "fundamentally inconsistent" with the premise on which the deduction was initially based, even in situations where there is no actual recovery of funds. Id. at 381-383. One must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions. Id. at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See American Mutual Life Insurance Co. v. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

Section 419(a) 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(b) limits the employer's deduction under section 419(a) to a welfare benefit fund's qualified cost for the taxable year. The qualified cost of a welfare benefit fund for a taxable year is defined in section 419(c)(1) as the sum of the qualified direct cost for the taxable year and, subject to the limitation of section 419A(b), any addition to a qualified asset account for the taxable year. Under section 419(c)(2), the qualified cost for any taxable year is reduced by the welfare benefit fund's after-tax income for the taxable year.

Section 419(c)(3)(A) provides that the term "qualified direct cost" means, with respect to any taxable year, the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if those benefits were provided directly by the employer and the employer used the cash receipts and disbursements method of accounting.

Section 419(c)(3)(B) provides that, for purposes of section 419(c)(3)(A), a benefit is treated as provided when that benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for any provision of Chapter 1 of the Code excluding that benefit from gross income).

Section 419(e)(1) defines the term "welfare benefit fund" to include any fund through which the employer provides welfare benefits to employees or their beneficiaries. The term "fund" is defined in section 419(e)(3) to include an organization described in section 501(c)(9).

Section 419A(a) provides that the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of (1) disability benefits, (2) medical benefits, (3) SUB or severance pay benefits, or (4) life insurance benefits. Section 419A(b) provides that no addition to any qualified asset account may be taken into account under section 419(c)(1)(B) to the extent the addition results in the amount of the account exceeding the account limit.

Section 419A(c)(1) provides that, except as otherwise provided in this subsection, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund (A) claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in subsection (a), and (B) administrative costs with respect to the claims.

Section 419A(c)(2) provides that the account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees.

Section 4976(a) 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.

ANALYSIS

The amendment of Trust providing for a one-time transfer of Transferred Assets to Active Subaccount will allow amounts that were originally set aside to provide health and other welfare benefits for retirees to be used to provide health benefits to current employees.

As explained above, the tax benefit rule is implicated when a taxpayer has taken a deduction in a prior year, and in a subsequent year an event occurs that is fundamentally inconsistent with the premise of the deduction. The facts and circumstances of each case must be considered "in light of the purpose and function of the provisions granting the deductions." Hillsboro National Bank, 460 U.S. at 385. We conclude that the one-time transfer of Transferred Assets to Active Subaccount will implicate the tax benefit rule because Taxpayer deducted Transferred Assets in accordance with section 419A(c)(2) in prior years, but after the transfer Transferred Assets will be available to provide benefits to current employees, who are not covered under section 419A(c)(2). Thus, this use of Transferred Assets is fundamentally inconsistent with the premise of the prior deductions. Taxpayer has therefore represented that it will take the total amount of Transferred Assets into gross income under the tax benefit rule for the year in which Trust is amended and the one-time transfer of Transferred Assets to Active Subaccount occurs, and that no portion of Transferred Assets is excludable under the exclusionary part of the tax benefit rule, partially codified in section 111.¹

Based on the information submitted by Taxpayer, it does not appear that the amendment of Trust and the transfer to Active Subaccount and future use of Transferred Assets for purposes of providing health benefits to current employees for whom Taxpayer and its subsidiaries have no obligation to provide such benefits will result in any portion of Trust reverting to the benefit of Taxpayer. Thus, the amendment of Trust and the transfer and future use of Transferred Assets for purposes of providing health benefits to current employees will not result in a "disqualified benefit" within the meaning of section 4976(b)(1)(C), and such transfer and future use will not, in and of itself, cause Taxpayer to be liable for the excise tax imposed by section 4976.

Section 419(a) 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. Therefore, once Transferred Assets are includable in the gross income of Taxpayer under the tax benefit rule, Taxpayer may treat the amount of Transferred Assets transferred to Active Subaccount as a contribution and take a deduction in accordance with sections 419 and 419A.

¹ It is not necessary to consider whether Taxpayer will have an accession to wealth under section 61 because the amount of the aggregate deducted contributions exceeds the amount of Transferred Assets.

We assume for purposes of this ruling, and without expressing an opinion, that Taxpayer has the authority to complete the transactions described and that these transactions can otherwise be effectuated and do not fail to meet the requirements of other applicable federal and state law.

CONCLUSIONS

Based on the facts and representations provided by Taxpayer:

- (1) The transfer of Transferred Assets to Active Subaccount and future use of the assets for purposes of providing health benefits to current employees for whom the Taxpayer and its subsidiaries have no current or future obligation to provide such benefits will not be treated as a disqualified benefit under section 4976(b)(1)(C) of the Code and will not, in and of itself, result in excise tax under section 4976 of the Code.
- (2) The amount of Transferred Assets transferred to Active Subaccount and included in Taxpayer's gross income for 2017 will be treated as a contribution in 2017 within the meaning of section 419(a) of the Code.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2016-1, 2016-1 I.R.B. 1, § 7.01(15)(b). This office has not verified any of the material submitted in support of the request for ruling, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2016-1, § 11.05.

Except as expressly provided above, no opinion is expressed or implied concerning the federal income tax consequences of any other aspects of any transaction or item of income described in this letter ruling. Specifically, no opinion is expressed regarding the amount of any deductions under sections 419 and 419A, or whether Trust qualifies as an organization described in section 501(c)(9).

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Specifically, no opinion is expressed regarding the tax consequences of the described transactions to Trust under section 501(c)(9).

Sincerely,

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