

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Date:  
January 16, 2009

Legend

Taxpayer =

State =

County =

Trust =

Plan =

Dear :

This is in reply to your letter dated October 16, 2008 and subsequent correspondence, in which you request various rulings on behalf of Taxpayer with respect to Plan and Trust.

FACTS

Taxpayer is a school board that oversees the operation of the public schools in County. Taxpayer is a body politic and corporate existing under the laws of State. As a body politic and corporate of State, Taxpayer is a political subdivision of State.

Taxpayer adopted Plan as a means of providing health and welfare benefits to its retirees, their spouses, and eligible dependents. Taxpayer is the sole employer participating in Plan. Taxpayer is authorized to amend or terminate Plan.

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

Taxpayer represents that there are no pre-tax salary reduction elections under the Plan. In addition, Taxpayer represents that Plan does not permit a cash-out of unused amounts or a conversion of sick or vacation days to retiree health benefits. Participants may not salary-reduce to pay for any benefit.

Taxpayer does not currently provide benefits to individuals who do not qualify as a spouse or as a dependent under § 152 of the Internal Revenue Code (the Code). However, if Taxpayer extends benefits to a non-spouse or non-dependents, Taxpayer will take reasonable steps to identify individuals who do not qualify as a spouse or dependent and include in the income of participants the fair market value of the coverage for any such individual.

Plan provides that each benefit provided by Taxpayer that is a self-insured medical expense reimbursement plan benefit shall comply with the nondiscrimination requirements of section 105(h) of the Code and the Income Tax Regulations thereunder.

Taxpayer created Trust to provide a vehicle for funding retiree benefits under Plan. The income of Trust consists solely of contributions from Taxpayer and investment income. Trust assets will be used to pay for Plan benefits and for the administration of Trust. In addition, Trust will establish and accumulate a reserve fund to pay for health benefits for future retirees. 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. No part of Trust's net earnings may inure to the benefit of any private person. The parties to the Trust Agreement are Taxpayer and the trustee of Trust. The trustee is the person currently serving as the Director of Finance of the County public schools.

Taxpayer may terminate Trust at any time for any reason. Upon termination of Trust, the remaining assets of Trust will be transferred to one or more trust funds to be used exclusively for the purpose of providing health and welfare benefits to the participants of Plan. In the event the assets are not transferred to such a trust fund, the assets may be transferred to Taxpayer or to County. In no event will the assets be transferred to an entity which 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 indicates 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 the 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 the Trust satisfies an obligation the Taxpayer has assumed with respect to providing benefits to its employees. The benefit to the participating employees, their spouses and dependents is incidental to the public benefit. See Rev. Rul. 90-74.

Section 6012(a)(4) of the Code provides, in general, that every trust having for a taxable year any taxable income, or having gross income of \$600 or more, regardless of the amount of taxable income, shall make returns with respect to income taxes under subtitle A. However, no annual return is required to be filed by Trust if income realized by Trust is excluded from gross income under § 115(1).

Section 7701(a) and § 301.7701-4 of the Procedure and Administration Regulations define trusts for purposes of §6012. Section 301.7701-4(a) provides, in general, that an arrangement will be treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

In this case, the Taxpayer contributes money to the Trust to provide health benefits for former employees, their spouses and dependents. The trustee of Trust is given responsibility to protect and conserve the Trust's assets for the beneficiaries who cannot share in the discharge of this responsibility and, therefore, is not an associate in a joint business for profit.

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 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 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) Trust income 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) Trust is not required to file an annual income tax return under § 6012(a)(4) of the Code.
- (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 and their spouses and dependents (as defined in § 152 of the Code) are excludable from the gross income of retired employees and retired employees' spouses and dependents 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. In particular, § 3.01(10) of Rev. Proc. 2008-3, 2008-1 I.R.B.112 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, Chief  
Health and Welfare Branch  
Associate Counsel/Division Counsel  
(Tax Exempt & Government Entities)