Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200210025**
Release Date: 3/8/2002
Index Numbers: 79.00-00; 115.06-00;
419A.00-00; 4976.01-00

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11/30/2001

<u>Legend</u>

State =

Insurance Company =

Trust =

State Statute <u>I</u> =

Dear

This is in response to a letter dated December 8, 2000, from the State's authorized representatives requesting rulings concerning the transaction described below.

The State sponsors and maintains several welfare benefit plans, including a group-term life insurance program. This program and others are funded in part through a cafeteria plan maintained pursuant to section 125 of the Internal Revenue Code.

In the 1980's, Insurance Company issued a group-term life insurance policy to the State, providing life insurance benefits to the State's active and retired employees (the Old Program). Various classes of employees received life insurance benefits under the Old Program. (For purposes of this letter, "employees" includes former employees and retired employees, as appropriate.) The benefits provided and the amount of required employee contributions varied by class. Retired employees paid the full cost of the premiums for their coverage.

One class of employees covered by the Old Program was disabled employees. In order to fund the payment of premiums for this class of employees, the State and Insurance Company created an advance premium account (the Fund). Dividends from the Old Program's group-term life insurance policy issued by Insurance Company were also deposited to the Fund. Those dividends were derived from claims experience and inadvertent premium surpluses allocable to all classes of employees. Amounts in the Fund increased significantly over the years.

A decision was made to improve upon the group-term life insurance benefits offered to State employees and, at the same time, address the increasing amounts in the Fund. As a result, the State has terminated the Old Program, competitively bid a new life insurance program (the New Program), and entered into a new policy with Insurance Company to maintain the New Program. Pursuant to an amended agreement with Insurance Company, the insurer transferred assets of the Fund to a trust fund (the Trust) created by State Statute I. Those assets are currently being held in the Trust for the purpose of providing enhanced benefits under the New Program to State employees and retirees at a reduced cost.

The New Program provides for additional life insurance benefits to be provided by the State. A portion of the State's costs will be paid through the assets in the Trust, as long as the Trust has not been depleted. Under the New Program, no part of the Fund will be applied to provide any post-retirement benefit that would discriminate in favor of any highly compensated employee. While the New Program now allows some retiree costs to be offset by amounts from the Trust, there is no guarantee to any retiree of benefits other than as each year's premium is paid.

The assets of the Fund are currently and will at all times be held in the Trust in the State Treasury for active State employees, disabled State employees, and specified retirees, and utilized to pay premiums to Insurance Company under the New Program. This is required by State Statute I. Under that statute, the assets of the Trust must be used to benefit the State employees and retirees (by providing increased benefits or reduced premiums, or to pay for administration of the State's group insurance program). The State represents that no Trust assets nor the earnings or float on those assets may be used for any other State purpose.

Rulings are requested concerning the status of the Fund and the Trust for purposes of Federal income taxation, the application of sections 419A(g) and 4976 of the Code to the transactions, the status of the benefits provided to employees through the Fund and the Trust for purposes of section 79, and the treatment of pre-tax contributions to the cafeteria plan for purposes of section 125.

LAW AND ANALYSIS

Status of the Fund and the Trust for Purposes of Federal Income Taxation

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-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 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 a public utility 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 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(1) of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

The collection and investment of premium surpluses collected by the State in order to utilize the funds for meeting expenses and providing increased benefits or to reduce premiums for state group-insurance program participants is a necessary incident of the power of the State to collect taxes and other revenues for use in meeting governmental expenses. The investment of funds by a State or political subdivision in the kind of fund involved in this case constitutes the exercise of an essential governmental function for purposes of section 115(1) of the Code.

No income from the Fund or the Trust accrues to any private person or entity. The State has the right to provide health insurance benefits to State employees and retirees. The State is the sole beneficiary of the Fund and the Trust, which is held in the State's Department of Treasury. Accordingly, the income of the Fund and the Trust is excludable from gross income under section 115(1).

Application of Section 419A(g) of the Code

Section 61 of the Code provides that gross income means all income from whatever source derived, except as otherwise provided.

Rev. Rul. 87-2, 1987-1 C.B. 18, provides that income earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income. Rev. Rul. 87-2 notes that an example of a statutory exception to this general rule is found in section 511(a)(2)(B) of the Code, under which the unrelated business taxable income of colleges and universities that are state agencies or instrumentalities is taxable.

In general, sections 419 and 419A of the Code prescribe limitations on deductions for contributions paid or accrued by an employer to a welfare benefit fund. In addition, under specified circumstances section 419A(g) operates to cause an employer to include in its gross income the welfare benefit fund's deemed unrelated income.

Section 419(e) of the Code defines the term "welfare benefit fund" as any fund that is part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries. The term "welfare benefit" means any benefit other than a benefit with respect to which section 83(h), section 404, or section 404A applies. Pursuant to section 419(e)(3), the term “fund” means - -

(A) any organization described in section 501(c)(7), (9), (17), or (20);
(B) any trust, corporation, or other non-exempt organization, and
(C) to the extent provided in regulations, any account held for an employer by any person.

Section 1.419-1T, Q&A-3(c), of the regulations provides in pertinent part that the term “fund” includes a retired lives reserve or a premium stabilization reserve maintained by an insurance company, if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years’ benefit costs or insurance premiums. Also, if an employer makes a payment to an insurance company under an “administrative services only” arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement would be considered a “fund.” Finally, an insurance or premium arrangement between an employer and an insurance company is a “fund” if, under the arrangement, the employer has a right to a refund, credit, or additional benefits (including upon termination of the arrangement) based on the benefit or claims experience, administrative cost experience, or investment experience attributable to such employer.

Section 419(e)(4) of the Code (enacted after the issuance of section 1.419-1T of the regulations) provides that notwithstanding section 419(e)(3)(C) of the Code, the term “fund” shall not include amounts held by an insurance company pursuant to an insurance contract if the contract is a life insurance contract described in section 264(a)(1) of the Code, or the contract is a qualified nonguaranteed contract. Section 419(e)(4) was added to the Code by section 1851(a)(8)(A) of the Tax Reform Act of 1986 (TRA’86). Section 1851(a)(8)(B) of that Act provides that except in the case of a reserve for post-retirement medical or life insurance benefits and any other arrangement between an insurance company and an employer under which the employer has a contractual right to a refund or dividend based solely on the experience of such employer, any account held for an employer by any person and defined as a fund in regulations issued pursuant to section 419(e)(3)(C) of the Code shall be considered a “fund” no earlier than six months following the date those regulations are published in final form.

Section 419A(g) of the Code requires an employer maintaining a welfare benefit fund that is not an organization described in section 501(c)(7), (9), (17), or (20) to include in income the fund’s deemed unrelated income. “Deemed unrelated income” is the amount that would have been the fund’s unrelated business taxable income under section 512(a)(3) if the fund were an organization described in section 501(c)(7), (9), (17), or (20).

Section 512(a)(3) of the Code, in general, defines “unrelated business taxable income” of an organization described in section 501(c)(7), (9), (17), or (20) as the gross income (excluding any exempt function income), less deductions directly connected with the production of the gross income (excluding exempt function income), and computed with certain modifications. “Exempt function income” generally means members' dues, fees, or similar amounts. It also includes income set aside to pay life, sick, accident, or other benefits. Pursuant to section 512(a)(3)(E), for purposes of determining the exempt function income, a setaside to pay those benefits is generally limited to the section 419A account limit. Under section 512(a)(3)(E)(iii), however, this limitation does not apply to any organization if substantially all of the contributions to the organization are made by employers exempt from tax under Chapter 1 of the Code.

The information provided in this case indicates that the Fund and the Trust are "welfare benefit funds" within the meaning of section 419(e) of the Code and section 1.419-1T, Q&A3(c), of the regulations.[1] Nevertheless, we conclude that section 419A(g) does not cause taxable income to be recognized in this case.

Sections 419 and 419A of the Code apply in connection with an employer making contributions to a welfare benefit fund. In this case the employer is the State or an agency or instrumentality of the State. Absent specific statutory authorization for taxing such income, the income of a state, including its agencies and instrumentalities, is not taxable. Pursuant to section 511(a)(2)(B) of the Code, colleges and universities that are state agencies or instrumentalities, including corporations owned by the colleges and universities, are taxable on the gross income from any unrelated trade or business, less the deductions allowed by chapter 1 of the Code that are directly connected with the carrying on of the unrelated trade or business.

Section 419A(g) of the Code requires an amount equal to a welfare benefit fund's "deemed unrelated income" to be included in the gross income of the employer if the fund is not an organization described in section 501(c)(7), (9), (17), or (20). Neither the Fund nor the Trust is one of these organizations. However, with the possible exception of colleges or universities of the State, there is no specific statutory authorization to tax the State, or its agencies or instrumentalities, with respect to the deemed unrelated income described in section 419A(g). Further, even if section 419A(g) is viewed as applying in connection with the portion of the Fund and Trust attributable to colleges and universities of the State because they are taxable on unrelated business income, we conclude that all of the Fund and Trust's income is "exempt function income" because (1) it is set aside to pay life, sick, accident, or other benefits, and (2) the section 419A limitation does not apply to the calculation of the exempt function income in this case because substantially all of the contributions to the Fund and Trust are made by employers exempt from tax. Thus, the Fund and Trust have no "deemed unrelated income" and there are no tax consequences under section 419A(g).

<u>Applicability of the 100% Excise Tax of Section 4976 of the Code</u>

Section 416(i) of the Code defines the term "key employee" for purposes of various Code provisions, including sections 419A and 4976. That definition specifically excludes from the term "key employee" any officer or employee of any State or any of

[1]Although section 419(e)(4) of the Code and section 1851(a)(8)(B) of the TRA'86 may limit the application of Q&A-3(c) under some circumstances, those provisions do not affect the result in this case.

its political subdivisions, or by any agency or instrumentality of any State.

Section 419A(d) of the Code requires the payment of post-retirement medical or life insurance benefits provided to a key employee be paid only from a separate account established for that employee.

Section 505 of the Code provides for additional requirements that must be met by an organization described in section 501(c)(9) or (20) that is part of a plan. Section 505(b) provides, in pertinent part, that the coverage of a plan providing post-retirement benefits must not discriminate in favor of employees who are highly compensated individuals.

Section 4976(a) of the Code imposes an excise tax on an employer equal to 100 percent of any disqualified benefit provided by a welfare benefit fund.

Section 4976(b)(1)(A) of the Code provides that the term "disqualified benefit" includes any post-retirement medical or life insurance benefit provided with respect to a key employee if a separate account is required to be established for that employee under section 419A(d) and the payment is not from that account.

Section 4976(b)(1)(B) of the Code provides that the term "disqualified benefit" includes any post-retirement medical or life insurance benefit provided with respect to an individual in whose favor discrimination is prohibited unless the plan meets the requirements of section 505(b) with respect to that benefit (whether or not those requirements apply to the plan).

Section 4976(b)(1)(C) provides that the term “disqualified benefit” also includes 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) shall not apply to any amount attributable to a contribution to a welfare benefit fund that is not allowable as a deduction under section 419 for the taxable year or any prior taxable year.

We conclude that no part of the transaction described above constitutes a “disqualified benefit” within the meaning of section 4976. The use of assets of the Fund or the Trust in connection with the New Program will not result in a disqualified benefit under section 4976(b)(1)(A) of the Code because the term “key employee” as defined in section 416(i) does not include officers or employees of the State. Nor will the use of the assets result in a disqualified benefit under section 4976(b)(1)(B) because no discriminatory benefit will be provided under the program to any highly compensated employee. Finally, the transaction does not result in a reversion under section 4976(b)(1)(C) of the Code. The transfer of assets from the Fund to the Trust is merely a transfer from one welfare benefit fund to a successor welfare benefit fund where the assets will continue to be used for the payment of welfare benefits.

<u>Status of Program Benefits Under Section 79</u>

Section 79 of the Code provides for the income tax treatment of group-term life insurance provided for employees.

Section 1.79-1(a) of the regulations provides that life insurance is not group-term life insurance for purposes of section 79 of the Code unless: (a) it provides a general death benefit that is excludable from gross income under section 101(a); (b) it is provided to a group of employees; (c) it is provided under a policy carried directly or indirectly by the employer; and (d) the amount of insurance provided to each employee is computed under a formula that precludes individual selection.

Section 1.79-1(b) of the regulations requires additional conditions to be met if the policy that provides the group-term life insurance also provides a permanent benefit. A "permanent benefit" is defined in section 1.79-0 as an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. However, a feature that provides no economic benefit to the employee (other than current insurance benefit) is not a permanent benefit.

No employee or retiree of the State has rights under the State's life insurance program to anything more than current life insurance protection. Thus, we conclude that neither the existence of the Fund, nor the transfer of the assets of the Fund to the Trust will cause the insurance provided to the employees to fail to constitute group-term life insurance within the meaning of section 79 of the Code.

Treatment of Pre-tax Contributions to the Cafeteria Plan

Rev. Proc. 2001-3, 2001-1 I.R.B. 111, sec. 3.01(13), provides that the Internal Revenue Service will not issue rulings as to whether amounts used to provide group-term life insurance under section 79 of the Code, accident and health benefits under sections 105 and 106, and dependent care assistance programs under section 129 are includible in the gross income of participants when the benefits are provided through a cafeteria plan. Accordingly, this letter makes no conclusions with respect to the tax consequences of the transaction described above under section 125 of the Code.

RULINGS

1. The income of the Fund and the Trust is excludable from gross income for federal income tax purposes under section 115 of the Code.

2. Sections 419 and 419A of the Code do not operate to cause the State, the Trust, or the Fund to recognize taxable income.

3. The termination of the Old Program, and the transfer incident to such termination of the Fund to the Trust under the New Program, will not be deemed an impermissible reversion to the benefit of the employer, and thus will not result in a 100% excise tax under section 4976(b)(1)(C) of the Code.

4. The use of Fund assets in connection with the New Program will not result in a 100% excise tax under section 4976 of the Code through application of section 4976(b)(1)(A) or 4976(b)(1)(B).

5. Neither the existence of Fund assets, nor the transfer of Fund assets to the Trust

for use under the New Program, will cause either the insurance provided under the old policy or the new policy to fail to constitute group-term life insurance within the meaning of section 79 of the Code and section 1.79-0 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. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any provision of the Code.

Sincerely,
MARK SCHWIMMER
Senior Technical Reviewer
Division Counsel/Associate Chief Counsel
(Tax Exempt and Governmental Entities)

Enclosure: Copy for §6110 purposes