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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

T:EO: B2

Date: APR 9 2003

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List: 61.00-00
501.09-00
1001.00-00
4976.00-00

Legend:

Trust A =

Trust B =

Company M =
Company N =
Company P =

Policy E =
Policy F =
Policy G =

Reserve =

Plan J =
Plan K =

State V =

x =

Date Y =
Date Z =
Date AA =

Dear Sir or Madam:

We have considered your letters dated July 9, 2002, and December 11, 2002, in which you request rulings regarding the tax consequences of a proposed transfer of assets held in a retired health reserve to a voluntary employees' beneficiary association (VEBA).

Facts:

According to the information provided, Company M is a life insurance company within the meaning of section 816(a) of the Internal Revenue Code (the "Code") and taxable as such under section 801. Company M is a member of an affiliated group of corporations, the common parent of which is Company N.

Company M maintains a group health plan (the "Health Plan") for the benefit of its active and retired employees (and their dependents), as well as the active and retired employees (and their dependents) of its affiliated companies. Parts of the retiree coverage under the Health Plan are insured under the following policies ("Policies") issued by Company M:

1. Policy E, for all active employees, disabled employees and retirees on or after Date Y;
2. Policy F, for all employees who retired or became disabled prior to Date Y, excluding State V residents; and
3. Policy G, for employees who were State V residents and retired or became disabled prior to Date Y.

The Health Plan provides two medical coverages: Plan J for participants who are not eligible for Medicare, and Plan K for participants who are Medicare eligible. Each Plan has several options that have different deductibles and pay different levels of benefits.

Company M subsidizes the active and retiree medical coverages. The amount of the subsidy is determined based on a number of factors including length of service, number of covered dependents and eligibility for Medicare.

Under the Policies, Company M maintains Reserve, a welfare benefit fund under section 419(e) of the Code, to provide post-retirement medical benefits for eligible retirees. Each Policy provides that the Reserve is to be used exclusively to provide post-retirement medical benefits to eligible retirees who are not "key employees" as defined under the Code. The Policies also provide that, in the event that such Policies are terminated, any balance remaining in the Reserve is to be used to provide continuing post-retirement medical coverage for as long as any eligible retiree remains alive. At the time of the death of the last surviving eligible retiree, any balance in the Reserve shall then be used, as permitted by applicable law, for the sole benefit of active or retired employees of Company M and other participating Employers.

The Reserve consists of two account balances, one maintained for non-represented retirees and the other for represented retirees, which are used to pay the retiree medical coverages for its respective members. As of Date Z, the balance in the Reserve for non-represented retirees was approximately $53x, and for represented retirees approximately $4x.

Company M also maintains two VEBAs. Each VEBA provides funding for post-retirement medical benefits.

Trust A provides for the funding of (i) post-retirement medical benefits for eligible non-represented retirees (other than key employees as defined in section 419A(d)(3) of the Code), and (ii) certain other benefits for these retirees, which may be designated by Company M from time to time, including life, sick, accident, and other similar benefits.

Trust B provides for the funding of (i) post-retirement medical benefits for eligible represented retirees (other than key employees as defined in section 419A(b)(3) of the Code), and (ii) certain other benefits for these retirees, which may be provided under a Trust which is tax exempt under section 501(c)(9) of the Code.

Trust A and Trust B are recognized as tax exempt under section 501(c)(9) of the Code.

Like the Reserve held under the Policies, each Trust provides that all contributions to such Trusts and all earnings on those contributions must be used for the exclusive benefit of eligible retirees identified therein. Moreover, each Trust provides that, upon termination of the VEBAs, any balance remaining in the Trust must be used to provide post-retirement medical benefits under Company M's Health Plan for as long as any eligible retiree (or their dependents) remains alive and covered by the Health Plan. At the time of the death of the last surviving eligible retiree, any balance in the Trust shall then be used, as permitted by applicable law, for the sole benefit of active or retired employees of Company M and other participating Employers.

Commencing Date AA, most non-represented employees of Company M will be transferred to a newly created services company known as Company P. Company P is a direct and wholly-owned subsidiary of Company N, which is also the 100% parent company of Company M. Thus, both Company M and Company P are members of the same controlled group of corporations.

Under a service contract between Company M and Company P that is effective starting Date AA, Company P employees (the former employees of Company M and newly hired employees) will perform services for Company M and, in return, Company P will be compensated by Company M for the employee costs (salary and benefits) attributable to such Company P employees.

It is intended that all employees of Company M that are transferred to Company P have the same level of employee benefit coverage that they would have had if they had remained in the employ of Company M. Thus, in the case of the Health Plan, the transferred employees will retain the same eligibility standards and receive the same employer cost subsidies that they would have had with Company M. To that end, Company P will adopt the Health Plan as a participating Employer for its own employees. In addition, Company P will become a participating Employer in Trust A.

In order to simplify the administration of the Health Plan and provide greater flexibility, Company M proposes to transfer up to all of the amounts held in the Reserve for non-represented retirees to Trust A and up to all of the amounts held in the Reserve for represented retirees to Trust B.

Rulings Requested:

The following rulings have been requested:

1. Neither the transfer of amounts held in the Reserve from Company M to Trust A and Trust B, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will result in the realization or recognition of gross income or gain to Company M under sections 61 or 1001 of the Code.

2. Neither the transfer of amounts held in the Reserve from Company M to Trust A and Trust B, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will constitute a reversion subject to the 100 percent excise tax under section 4976 of the Code.

3. Neither the transfer of amounts from the Reserve to Trust A and Trust B, nor the use by the Trusts of these amounts to pay post-retirement medical benefits and related administrative expenses, will cause the Trusts to lose their exemption from tax under section 501(a) of the Code as an organization described in section 501(c)(9).

Law:

Section 61(a) of the Internal Revenue Code provides that, unless otherwise excepted, gross income includes all income from whatever source derived, including income from lire insurance and endowment contracts.

Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund, if they would otherwise be deductible, shall be deductible (subject to limitations) under section 419 for the taxable year in which paid.

Section 419(e)(1) of the Code provides that the term "welfare benefit fund" means any fund which is part of a plan of an employer and through which the employer provides welfare benefits to employees or their beneficiaries.

Section 419(e)(3) of the Code provides that the term "fund" means, among other things, any account held for an employer by any person, to the extent provided in regulations.

Section 1.419-1T of the Income Tax Regulations, Q&A-3, states that a retired lives reserve maintained by an insurance company is a "fund," or part of a "fund," 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.

Section 4976(a) of the Code imposes an excise tax in the amount of 100 percent of the amount of any disqualified benefit provided by a welfare benefit fund.

Section 4976(b)(1)(C) of the Code defines the term "disqualified benefit" to include any portion of a welfare benefit fund reverting to the benefit of the employer.

Section 501(c)(9) of the Code provides for exemption from federal income taxation for voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-1 of the regulations provides that, to be described in section 501(c)(9) of the Code, an organization must meet the following requirements: the organization is an employees' association; membership in the association is voluntary; the organization provides for the payment of life, sick, accident, or other benefits to its members or their dependents or designated beneficiaries; and, no part of the net earnings of the organization inures, other than by payment of the aforementioned benefits, to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-4(a) of the regulations provides that no part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of permissible benefits. Whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances.

Section 1.501(c)(9)-4(d) of the regulations provides that it will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in section 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide either directly or through the purchase of insurance, life, sick, accident, or other benefits within the meaning of section 1.501(c)(9)-3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. Similarly, a distribution to members upon the dissolution of the association will not constitute prohibited inurement if the amounts distributed to members are determined pursuant to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Except as otherwise provided in the first sentence of this paragraph, if the association's corporate charter, articles of association, trust instrument, or other written instrument by which the association was created, provides that on dissolution its assets will be distributed to its members' contributing employers, or if in the absence of such provision the law of the state in which the association was created provides for such distribution to the contributing employers, the association is not described in section 501(c)(9).

Revenue Ruling 69-382, 1969-2 C.B. 28, holds, in part, for taxable years ending on or before June 17, 1969, premiums paid or incurred by an employer policyholder under contracts providing group term life and health and accident coverage for its active and retired employees were deductible in full even though a portion of the premium was credited to a retired lives

reserve if (1) the balance in the reserve was held by the insurance company solely for the purpose of providing insurance coverage on active and retired lives so long as any active and retired employees remained alive, and (2) the amount added to the retired lives reserve was not greater than an amount that would be required to fairly allocate the cost of the insurance coverage provided over the working lives of the employees involved. Further, the ruling holds, in pertinent part, that these conclusions would be applicable to taxable years ending after June 17, 1969, provided that the employer policyholder promptly amended the contract to provide that it did not retain any right to recapture any portion of the reserve so long as any active or retired employee remains alive.

In Revenue Ruling 73-599, 1973-2 C.B. 40, the issue was whether the balance in a retired lives reserve had to be included in the gross income of the employer in the taxable year in which the employer terminated the insurance contract. At the time it terminated the insurance contract, the employer directed that the insurance carrier should transfer the balance in the retired lives reserve to a trust qualified as a VEBA under section 501(c)(9) of the Code. The employer had deducted the premiums paid into a retired lives reserve during the years when it was maintaining the insurance contract for the benefit of its employees. The insurance contract provided that, upon cancellation or other termination of the contract, any balance in the retired lives reserve could be distributed to the employer as a dividend or, at the employer's option, transferred to a trust qualified under section 501(c)(9) for the purpose of providing insurance coverage for retired employees. Under these facts, the ruling holds that the balance in the retired lives reserve was includable in the employer's gross income under section 61(a) in the year of the transfer. The ruling states that, because the insurance contract gave the employer a fixed right to receive the balance in the retired lives reserve in the year in which it terminated its coverage under the policy, that balance was includable in the employer's gross income for the year of the termination, notwithstanding the fact that the employer directed the insurance company to transfer the money to a section 501(c)(9) trust.

Similarly, in Revenue Ruling 77-92, 1977-1 C.B. 41, a corporate employer with a group term insurance program that included a retired lives reserve had the option to discontinue the insurance coverage and to direct the insurance carrier to use the amount in the retired lives reserve either to pay premiums for insurance on the lives of retired employees or to pay a dividend to the employer. The employer terminated the insurance contract and directed the insurance carrier to transfer the balance in the retired lives reserve to another insurance company to purchase insurance for retired employees. The ruling states that the facts presented are in substance the same as those contained in Rev. Rul. 73-599, except that the right reserved to the employer in Rev. Rul. 77-92 to transfer the funds remaining in the retired lives reserve consisted of the right to direct payment to those funds to another insurance company rather than to a trust that qualified for exemption under 501(c)(9) of the Code. However, this difference was not considered material because the taxpayer's right of control over the retired lives reserve was substantially the same in both cases. Accordingly, the ruling concludes that the same federal income tax rules apply to the transfers in the two cases.

Analysis:

The Reserve is a retired lives reserve maintained to provide post-retirement medical benefits to eligible retirees of Company M and other participating Employers. As such, the Employer has the right to have the amounts in the Reserve applied against its future years' benefit costs or insurance premiums. Consequently, the Reserve is a "welfare benefit fund" under section 419(e) of the Code.

The funds in the Trusts, like the amounts held in the Reserve, will be used to pay post-retirement medical benefits (and related costs) for retirees. Trust A, established for non-represented retirees, will receive only those Reserve amounts that have been allocated for non-represented retirees. Similarly, Trust B, established for represented retirees, will receive only those Reserve amounts that have been allocated for represented retirees.

The transfer of a retired lives reserve maintained under an insurance policy, and subject to sections 419 and 419A of the Code, to a VEBA does not result in a reversion to the employer, or cause the VEBA to lose its tax-exempt status under section 501(c)(9), when the policy clearly provides that such reserve is to be used solely for the purpose of providing coverage on active or retired lives for so long as any active or retired employee remains alive.

The Policies prohibit the reversion of any amounts held in the Reserve to Company M as long as any eligible employee or retiree of a participating Employer remains alive. Similarly, the Trusts that will receive the proceeds of the Reserve contain provisions prohibiting any reversion of the Trusts' assets to Company M while any eligible employee or retiree of a participating Employer remains alive.

In addition, both the Policies and the Trusts require that, after the death of the last surviving eligible retiree under the Health Plan, any balance remaining in the Reserve or Trusts must be used for the sole benefit of active or retired employees as permitted by applicable law. These provisions preclude Company M from receiving a reversion from either the Reserve or the Trusts, and thus distinguish this case from the revenue rulings discussed above. Accordingly, the transfer by Company M of amounts from the Reserve to the Trusts should not give rise to taxable income under sections 61 and 1001, nor should it be considered a reversion to Company M under section 4976 of the Code, nor should it result in any impermissible inurement for any employee, retiree, or Company M.

Conclusion:

Therefore, based on the information submitted, and the representations made therein, we conclude as follows:

1. Neither the transfer of amounts held in the Reserve from Company M to Trust A or Trust B, nor the use by the Trusts of those amounts to pay post-retirement medical benefits and related administrative expenses, will result in the realization or recognition of gross income or gain to Company M under section 61 or 1001 of the Code.

2. Neither the transfer of amounts held in the Reserve from Company M to Trust A or Trust B, nor the use by the Trusts of those amounts to pay post-retirement medical benefits and related administrative expenses, will constitute a reversion subject to the 100% excise tax under section 4976 of the Code.

3. Neither the transfer of amounts held in the Reserve from Company M to Trust A or Trust B, nor the use by the Trusts of those amounts to pay post-retirement medical benefits and related administrative expenses, will cause either Trust to lose its exemption from tax under section 501(a) of the Code as an organization described in section 501(c)(9).

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2