

INTERNAL REVENUE SERVICE  
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July 13, 1999

Taxpayer =

Corporation =

Trust =

Plan =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

X =

Y =

Dear

This is in response to your ruling request dated March 17, 1999, requesting rulings regarding the use of amounts held in a separate account in Trust (Separate Account), which was established to provide post-retirement life insurance benefits, to

provide other types of welfare benefits.

## FACTS

On Date 1, Corporation spun off some of its businesses to Taxpayer. In connection with the spinoff of Taxpayer, Corporation transferred sponsorship of certain benefit plans and trusts to Taxpayer. All references to Taxpayer include references to Corporation before the spinoff.

Taxpayer is the common parent of an affiliated group of companies that files a consolidated federal income tax return on a calendar year basis. Taxpayer files a Form 5500 on a calendar year basis with respect to employee benefit plans funded by Trust.

Effective on Date 2, Taxpayer established Trust as a voluntary employees' beneficiary association (VEBA) under section 501(c)(9) of the Internal Revenue Code for the purpose of funding one or more employee welfare benefit plans maintained by Taxpayer for employees of Taxpayer and the various subsidiaries forming Taxpayer's controlled group, including Plan. The Service issued Trust a letter on Date 3, stating that Trust is exempt under section 501(a) of the Code, and a subsequent letter on Date 4, stating that certain amendments did not affect the exempt status of Trust. Taxpayer files a Form 990 on behalf of the Trust on a calendar year basis.

On Date 5, Taxpayer received a private letter ruling concluding that Taxpayer could transfer to a separate account in Trust for the provision of post-retirement life insurance benefits certain amounts accumulated in retirement funding accounts (RFAs) under group insurance policies maintained by Taxpayer and its subsidiaries without the realization or recognition of gross income under section 61 of the Code and without a reversion and excise tax resulting under section 4976 of the Code (the RFA Ruling). At the time Taxpayer requested the RFA Ruling, Taxpayer amended the Trust to add the following provision:

All amounts transferred to the Trustee from retirement funding accounts maintained under group life insurance contracts between the Employer and one or more insurance companies shall be credited to the separate account for post-retirement life insurance benefits and used exclusively for the payment of post-retirement life insurance benefits.

The above provision also governs the operation of Plan. In reliance on the RFA Ruling, funds were transferred from various RFAs to Separate Account. The funds in Separate Account have been used solely to fund life insurance benefits for retired employees.

Taxpayer made contributions to the RFAs after December 31, 1985, but has not

made contributions to Trust. However, retirees have reimbursed Trust for the cost of supplemental life insurance coverage. Trust assets have been used solely for the payment of post-retirement life insurance benefits and to defray administrative expenses related to those benefits. The amounts transferred from the RFAs and the employee contributions are accounted for separately in the Trust. Nearly all of the growth in the employer portion of the RFAs and the Trust since 1985 is the result of investment returns.

Taxpayer's current group life insurance plan, Plan, continues to provide all regular active employees and all retired employees basic coverage at Taxpayer's cost, as well as the opportunity for active employees and certain retirees to purchase supplemental coverage. Plan is administered in accordance with the insurance policies in effect from time to time, the terms of the Plan, the terms of the applicable collective bargaining agreements, and the terms of Trust.

In Date 6, a portion of Trust was transferred to a trust established by Corporation that was intended to qualify as a VEBA under section 501(c)(9) of the Code. The amount of the assets transferred to the trust established by Corporation was equal to the accumulated postretirement obligation (as defined in Statement of Financial Accounting Standards No. 106) attributable to active and retired employees of Corporation.

As of Date 7, Separate Account was valued at over \$ X. The estimated disbursement cost for the year ending Date 8 will be approximately \$ Y. It is unlikely that the funds in Separate Account will ever be depleted if used solely to pay for basic retiree life insurance.

Taxpayer proposes to amend Trust to provide that amounts held in Separate Account that are attributable to employer contributions made to the RFAs prior to 1986 (Pre-1986 Contributions) may be used to provide welfare benefits other than postretirement life insurance benefits. For this purpose, Taxpayer determines the amount attributable to Pre-1986 Contributions as follows:

- (1) The amount attributable to Pre-1986 Contributions is determined without regard to employee contributions.
- (2) As of December 31, 1985, the amount attributable to Pre-1986 Contributions is equal to the fair market value of assets in the RFAs as of that date.
- (3) As of the end of any subsequent taxable year, the amount attributable to Pre-1986 Contributions is equal to the amount attributable to Pre-1986 Contributions as of the end of the previous taxable year, reduced by benefit payments, administrative expenses and other disbursements for the current taxable year, and increased by a pro-rata share of income

(including realized and unrealized gains and losses) for the taxable year determined as of the end of the current taxable year. The amount of the transfer to the trust established by Corporation is treated as a disbursement for this purpose.

## RULINGS REQUESTED

You have requested the following rulings:

1. Section 4976(b)(1)(C) does not apply if amounts held in Separate Account that are attributable to Pre-1986 Contributions are applied to provide welfare benefits other than postretirement life insurance benefits.
2. The use of amounts held in the separate account that are attributable to Pre-1986 Contributions to provide welfare benefits other than postretirement life insurance benefits will not adversely affect the exempt status of Trust under section 501(c)(9) of the Code.

## LAW AND ANALYSIS

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

Section 419(e)(1) of the Code 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) of the Code, and also, to the extent provided in regulations, any account held for an employer by any person. Paragraph (c) of regulation § 1.419-1T, 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 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund shall not be deductible under Chapter 1 of the Code, but if they would otherwise be deductible, shall (subject to the limitation of section 419(b)) be 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) of the Code 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 419A(a) of the Code defines the term "qualified asset account" to include any account consisting of assets set aside to provide for the payment of medical or life insurance benefits.

Section 419A(b) of the Code provides that no addition to any qualified asset account may be taken into account under section 419(c)(1) to the extent such addition results in the amount of such account exceeding the account limit.

Under section 419A(c)(1) of the Code, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year), and administrative costs with respect to those claims. Section 419A(c)(2) provides that the account limit for any taxable year may also include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary for post-retirement medical benefits or post-retirement life insurance benefits to be provided to covered employees.

Regulation §1.419-1T, Q&A-2(a), provides that section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date. Q&A-2(b) of that regulation provides a special transition rule for certain welfare benefit funds that are part of a plan maintained pursuant to one or more collective bargaining agreements, and Q&A-9 of that regulation provides special transition rules for the first taxable year of a fiscal year employer ending after December 31, 1985.

Section 501(a) exempts from federal income tax those organizations described in subsection (c).

Section 501(c)(9) describes voluntary employees' beneficiary associations

providing for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-4 of the Income Tax Regulations provides that whether prohibited inurement has occurred is a question to be determined with regard to all the facts and circumstances.

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 plan.

Section 4976(b)(1) provides that the term "disqualified benefit" means --

(A) any post-retirement medical benefit or life insurance benefit provided with respect to a key employee if a separate account is required to be established for such employee under section 419A(d) and such payment is not from such account,

(B) any post-retirement medical benefit 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 such benefit (whether or not such requirements apply to such plan), and

(C) any portion of a welfare benefit fund reverting to the benefit of the employer.

Section 4976(b)(3) of the Code provides that section 4976(b)(1)(C) does not apply to any amount attributable to a contribution to the fund that is not allowable as a deduction under section 419 for the taxable year or any prior taxable year.

Revenue Ruling 69-382 holds, in part, that 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 or 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.

The RFAs were retired lives reserves established to provide group life insurance to retirees of Corporation and were welfare benefit funds within the meaning of section 419(e). Trust is a welfare benefit fund as defined in section 419(e) because it is described in section 501(c)(9) of the Code and provides welfare benefits to employees of Taxpayer. Consequently, the deductibility of any contributions made to Trust and the RFAs after the effective date of section 419 is governed by section 419 of the Code, and any reversion to the benefit of Taxpayer of any portion of the Trust attributable to those contributions is subject to the excise tax under section 4976. However, as provided in Temporary Regulation §1.419-1T, Q&A-2, section 419 applies only to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date. In this case, only amounts attributable to contributions to Fund that were not "allowable as a deduction under section 419 for the taxable year or any prior taxable year" within the meaning of section 4976(b)(3) of the Code will be applied to other benefits. Accordingly, pursuant to that section, Code section 4976(b)(1)(C) does not apply to the amounts so applied.

Moreover, the use of amounts held in Separate Account that are attributable to Pre-1986 Contributions to provide welfare benefits constituting "life, sick, accident, or other benefits" within the meaning of section 501(c)(9) and the regulations thereunder should not result in prohibited inurement or otherwise affect the exempt status of Trust under section 501(c)(9) Code.

As we have previously discussed with you, in the interest of sound tax administration, we are declining to rule on the issue of whether the use of the separate account amounts attributable to Pre-1986 Contributions to provide welfare benefits other than postretirement life insurance benefits will result in the realization and recognition of gross income to Taxpayer under section 61 of the Code. Please note, however, that if the proposed use of Trust assets does result in the realization and recognition of gross income to Taxpayer under section 61, Taxpayer would be entitled to an offsetting deduction under section 419 for the qualified direct costs of providing welfare benefits.

## CONCLUSIONS

(1) Code section 4976(b)(1)(C) does not apply to Taxpayer's proposed use of amounts held in Separate Account that are attributable to Pre-1986 Contributions, because those contributions were not "allowable as a deduction under section 419 for the taxable year or any prior taxable year" within the meaning of section 4976(b)(3) of the Code.

(2) The use of amounts held in Separate Account that are attributable to Pre-1986 Contributions to provide welfare benefits constituting "life, sick, accident, or other benefits" within the meaning of section 501(c)(9) and the regulations thereunder will not adversely affect the exempt status of Trust under section 501(c)(9) Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(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. Specifically, no opinion is expressed about the computation of the account limit under section 419A(c) for purposes of computing Trust's unrelated business income under section 512(a)(3) of the Code. Moreover, if Trust or Plan is amended, these rulings may not remain in effect.

Sincerely yours,

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MARK SCHWIMMER  
Chief, Branch 4  
Office of the Associate  
Chief Counsel  
(Employee Benefits and  
Exempt Organizations)

Enclosure:  
Copy for section 6110 purposes