

INTERNAL REVENUE SERVICE  
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4976.00-00 4976.01-00  
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CC:EBEO:4-PLR-116586-98  
July 16, 1999

Taxpayer =

Fund =

Trust =

Corporation =

Insurance Company =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

X =

Dear

This is in response to your ruling request dated August 20, 1998, requesting rulings regarding the application of section 4976 of the Internal Revenue Code to the transfer of amounts held in Fund to Trust in order to provide postretirement medical benefits.

FACTS

Taxpayer is the common parent of an affiliated group that includes numerous wholly-owned subsidiary corporations. Taxpayer and its subsidiaries file a consolidated tax return, have a calendar year accounting period, and employ the accrual method of accounting. On Date 1, Taxpayer acquired Corporation. As part of this acquisition, Taxpayer became responsible for Fund, which is a retirement funding account under a group life insurance contract. Currently, Fund provides group life insurance benefits for retired employees of Taxpayer, Taxpayer's subsidiaries, and several defunct entities with surviving retired employees. Pursuant to an agreement with Insurance Company effective Date 2, monthly deposits were made to Fund. No contributions to Fund were made after Date 3, except that one of the participating employers made contributions to Fund to eliminate a negative balance. On a monthly basis, Insurance Company takes an actuarially-determined premium out of Fund to cover estimated retiree death claims filed by beneficiaries, plus expenses and premium taxes. On an annual basis, if necessary, a retrospective premium is withdrawn from Fund to cover claims and expenses in excess of monthly premiums. Similarly, if, after year-end, it turns out that monthly premiums exceeded actual claims plus expenses, then a dividend is deposited back into Fund.

Certain transfers to other welfare benefit funds have been made from Fund. Taxpayer previously received a private letter ruling dated Date 4 (PLR), which provided that (1) those transfers would not result in the recognition of gross income under section 61 of the Code by Taxpayer or its subsidiaries, and (2) those transfers would not result in excise tax under section 4976 of the Code.

An actuarial analysis performed as of Date 5 determined that the fair market value of the reserve exceeds the value of all life insurance obligations by approximately \$ X.

Taxpayer will establish Trust, which it intends to qualify as a voluntary employees' beneficiary association (VEBA) under section 501(c)(9) of the Internal Revenue Code. On an annual basis, effective with 1999 benefit payments and expenses, Fund will transfer to Trust the amount necessary to fund the current year's benefit payments for medical benefits of retired employees, plus administrative expenses to administer Trust. The transferred amount will not exceed the amount attributable to contributions made to fund prior to 1986 (Pre-1986 Contributions). 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 Fund 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 (including transfers to VEBA), 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.

### RULINGS REQUESTED

You have requested a ruling that section 4976(b)(1)(C) does not apply if amounts held in Fund that are attributable to Pre-1986 Contributions are transferred to Trust and are applied to provide retiree medical benefits. You also request a ruling that the amendment of the insurance agreement with Insurance Company will not affect the rulings provided to Taxpayer in PLR.

### 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 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.

Fund is a retired lives reserve under a group life insurance contract for the benefit of retired employees of Taxpayer and is a welfare benefit fund within the meaning of section 419(e). Consequently, the deductibility of any contributions made to Fund 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 Fund 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 transferred to Trust and applied to provide retiree medical benefits. Accordingly, pursuant to that section, Code section 4976(b)(1)(C) does not apply to the

amounts transferred.

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 transfer of amounts in Fund that are attributable to Pre-1986 Contributions to Trust 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 transfer of Fund assets to Trust 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 medical benefits to retirees.

### CONCLUSION

Code section 4976(b)(1)(C) does not apply to the proposed transfer to Trust of amounts held in Fund 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. Furthermore, the amendment of the insurance agreement with Insurance Company to provide for annual transfers to Trust of amounts not exceeding the remaining amount attributable to Pre-1986 Contributions will not affect the rulings provided to Taxpayer in PLR.

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 Fund's deemed unrelated income under sections 419A(g) and 512(a)(3) of the Code. Moreover, if Fund is amended, this ruling 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:

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