200404055

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Significant Index Nos.
419.11-00
419A.00-00

Date:
OCT 2 9 2003

Contact Person:

ID Number:

Contact Telephone:

Reference:
T:EO:RA:T:3

Legend:
M=
N=
O=

Dear Sir or Madam:

This is in response to a request for certain rulings under sections 501(c)(9), 512, and 419 of the Internal Revenue Code, submitted on M's behalf by M's authorized representative.

The information submitted indicates that M has been recognized as exempt under section 501(c)(9) of the Code. M is a trust established to provide certain medical benefits and other qualifying benefits for eligible participants, active and former employees of N, the employer. M provides benefits for participants under the N medical/dental plan.

N is a for-profit business entity. N is engaged in the business of manufacturing various products. N has made contributions to M to fund the obligation to pay medical benefits for active employees, known as "associates", and retirees.

Upon issuance of a favorable ruling by the Service, M intends to purchase a noncancellable retiree health insurance policy (the "Policy") to fund retiree health benefits under the M. M represents that provisions that are substantially similar to the provisions referenced in this ruling request will appear in the actual Policy.

Generally, the Policy would reimburse M for part of the benefits that M pays to retirees and their beneficiaries. Although M is used to pay benefits for both active and retired participants and their beneficiaries, the Policy would only insure the M for risks occurring after eligible associates have retired.

The Policy would be a noncancellable group accident and health insurance contract issued by O, a life insurance company that would indemnify M for certain health benefit liabilities incurred under the Medical Plan. The "Eligible Class," would consist of (a) active associates (and their dependents) who are covered under the Medical Plan or (b) retired associates (and their dependents) who are covered under the Medical Plan, or a combination of (a) and (b). No benefits would be payable to M under the Policy with respect to active associates and their dependents who are in the Eligible Class unless and until such associates retire while still covered by the Medical Plan. The "Covered Group" would consist of retired associates (and their dependents) who are among the Eligible Class.

Benefits under the Policy would be payable to M for health benefit liabilities incurred under the Medical Plan on behalf of members of the Covered Group; individual retirees and their dependents would have no rights and would receive no benefits under the Policy. Policy benefits would equal a percentage or dollar amount of the eligible medical expenses under the Medical Plan that exceeds a specified deductible amount.

In determining the premium O would take into account an assumed rate of interest (which may, but need not, equal the interest rate used in computing its statutory reserve). In other words, in computing a per-individual cost for the premium payment, O would assume that some of the original members of the Eligible Class will die or terminate employment before triggering benefit reimbursements under the Policy and that the premium payments will receive a certain investment return before and as benefits are paid. Once the Policy was issued, O could not increase premiums except in very limited circumstances involving governmental action.

O would allocate all premiums under the Policy to a separate investment account (the "Separate Account"). The Separate Account would be a segregated asset account established and maintained pursuant to the laws of the Commonwealth of Massachusetts. The Policy also provides that O would be the sole owner of the assets

in the Separate Account and would have the sole right to control, manage and administer the Separate Account. Further, all assets would be invested and reinvested in such investments as O in its sole discretion deemed appropriate consistent with the investment objectives established for the Separate Account. Such investment objectives would be formulated to meet the obligations guaranteed by the Policy and to adequately diversify the investments to meet any applicable federal tax and fiduciary standards. After such investment objectives were established, they could only be modified by mutual written agreement of the M and O.

M's discretion with respect to the assets in the Separate Account would be limited to nominating an investment manager from a pool of investment managers whose credentials have been evaluated and approved by O. Such investment manager candidates could be recommended to O by M. However, O would be under no obligation to follow any such recommendation. In no event would the M have the power to direct the purchase or sale of particular assets used to support O's obligations under the Policy.

As of the end of each accounting period under the Policy, O would withdraw from the Separate Account its charges for incurred claims and any pooled claims at such time as payment of such incurred claims and pooled claims became due. In addition, O would withdraw from the Separate Account an amount equal to the aggregate of the fees, expenses, costs and charges in connection with the Policy and/or the Separate Account, including but not limited to the following:

(a) O's charges for premium taxes and all other taxes and assessments of state, federal and other governmental agencies;

(b) O's fees and/or charges for administration, investment, marketing and other services, as well as insurance risk charges;

(c) custodial, transaction, brokerage and agent fees, commissions and charges;

(d) interest, fees, charges, repayments of principal and all other costs payable on borrowings, if any, by O in connection with the Separate Account; and

(e) any other direct expense in connection with the activities of the Separate Account or the protection of the investments allocated thereto.

O would guarantee a Policy fund known as the Termination Reserve. The Termination Reserve would mean a lump sum amount equal to the market value of the assets in the Separate Account, less the following amounts:

(a) all fees, expenses, costs and charges which have accrued but have not been withdrawn from the Separate Account;

(b) a reserve as determined by O for repayment of principal and other costs on borrowings, if any, in connection with the Policy and/or the Separate Account;

(c) a reserve as determined by O for claims and any pooled claims which have accrued and been reported to, but not yet paid by, O; and

(d) a reserve as determined by O for claims and any pooled claims, which have been, accrued but have neither been reported to nor paid by O.

The Termination Reserve would not be allocated in any way to individual members of the Eligible Class. The entire Termination Reserve value, even the portion that resulted from the aggregation of the per-individual cost for actively employed members of the Eligible Class, could be drawn upon to pay benefits for the Covered Group. O would guarantee the payment of Policy benefits, even if the Policy's Termination Reserve had been exhausted. Depletion of the Termination Reserve would not relieve O of its liability to reimburse the M with respect to all members of the Covered Group when benefit claims accrued.

O could terminate the Policy for failure of M to comply with any terms or conditions of the Policy. In addition, O could terminate the Policy if a governmental department or agency had an objection to the insurance arrangement; the insurance arrangement was prohibited or any penalties were imposed on O with respect to the arrangement under a law or a court or governmental agency ruling or decision; or there was legislation or court or government agency action or a settlement causing an increase in coverage, benefits or O's administrative expenses under the Policy.

The Policy would terminate automatically when there were no more persons in the Eligible Class. Also, at the direction of M and in accordance with Policy terms, the Policy could be terminated and the fair market value of the balance of the Termination Reserve could be transferred to O or another insurance company for application solely for the purpose of providing, or indemnifying M for, benefits under an employee benefit plan similar in nature to the Plan. Alternatively, M could elect to apply the balance of the Termination Reserve to provide coverage similar in nature to benefits provided under the Plan for members of the Covered Group.

In addition, the Policy as issued to M would state that M could withdraw the amount of the Termination Reserve in cash if there were no claims under the Policy for retiree health benefits for a period of twelve months (for example, if legislation was enacted instituting a government-sponsored or mandated health program that rendered the Taxpayer's coverage of retiree health benefits unnecessary or if the Medical Plan was terminated). M could not otherwise reach the funds under the Policy. Under applicable law, amounts received, as a result of the withdrawal in cash of the Termination Reserve would be required to be used to provide permissible VEBA

benefits. M's representative states that N, the employer, does not intend to take a deduction for the single premium funding necessary to purchase the Policy and assets in the Trust will not revert to the employer.

O could from time to time provide paid-up additional coverage for the Eligible Class under the Policy. Such paid-up additional coverage for the Eligible Class would arise from a direct participation provision of the Policy or through an apportionment of divisible surplus (or both). The rates charged for paid-up coverage could vary from the rates guaranteed for the base coverage, but such rates could not be increased and O could not cancel such coverage once the additional coverage has been provided. In either case, the value of the additional coverage would not be payable in cash to M. Thus, after the additional coverage was provided, the Policy would yield a greater benefit with respect to the Eligible Class under the Policy. However, in no event would the amount payable by O under the Policy exceed actual health benefits paid by the M under the Medical Plan.

Section 501(c)(9) of the Code provides for the exemption of voluntary employee 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 419(a)(1) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund shall be deductible.

Section 419(b) of the Code provides that the amount of the deduction allowable under subsection (a)(2) for any taxable year shall not exceed the welfare benefit fund's qualified cost for the taxable year.

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

Section 419A of the Code provides that for purposes of this subpart and section 512, the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of-

(1) disability benefits,
(2) medical benefits,
(3) SUB or severance pay benefits, or
(4) life insurance benefits.

Section 419A(c)(2)(A) of the Code provides that the account limit for any taxable year may include a reserve funded over the working lives of the covered employees

and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for post retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs).

Section 419A(g)(1) of the Code provides that in the case of any welfare benefit fund which is not an organization described in paragraph (7), (9), (17), or (20), of subsection (c), the employer shall include in gross income for any taxable year an amount equal to such fund's deemed unrelated income for the fund's taxable year ending within the employer's taxable year.

Section 419(A)(g)(2) of the Code provides that for purposes of paragraph (1), the deemed unrelated income of any welfare benefit fund shall be the amount which would have been its unrelated business taxable income under section 512(a)(3) of the Code if such fund were an organization described in paragraph (7), (9), (17), or (20) of section 501(c).

Section 511 of the Code imposes a tax on the unrelated business income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code describes the term "unrelated business taxable income" as the gross income derived by an exempt organization from any unrelated trade or business, as defined under section 513, regularly carried on by it, less certain deductions.

Section 512(a)(3)(B)(ii) of the Code provides that the term "exempt function income" means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set-aside, in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii).

Section 512(a)(3)(E) provides that in the case of an organization described in section 501(c)(9) of the Code, a set-aside for any purpose specified in clause (ii) of subparagraph (B) may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under 419A (without regard to subsection (f)(6) thereof) for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

M states that O will allocate all premiums paid under the Policy to a separate investment account. The separate account will be a segregated asset account

established and maintained pursuant to applicable state laws. M states that O, which will have the sole right to control, manage, and administer the account, will own assets in the account. N, the employer will have no control over funds maintained in the separate account maintained by O. The assets and income in the separate account will be used by M to provide medical benefits for the eligible class of employees and retirees (and their dependents) of N pursuant to section 419A of the Code. Therefore, distributions to M from the account will be used to accomplish M's stated purpose of providing medical benefits for employees and retirees of N pursuant to section 501(c)(9) of the Code. M's representative states that N, the employer, does not intend to take a deduction for the single premium funding necessary to purchase the policy.

The Policy purchased to provide medical benefits for employees and retirees of N will be owned by M. Section 419(e)(3)(C) of the Code includes in the definition of "fund" any account held for an employer by any person. Here M, an organization exempt under section 501(c)(9), rather than N, the employer, will hold the Policy. Section 419(e)(3)(C) addresses "accounts held for an employer." Since M is an organization recognized as exempt under section 501(c)(9), the income generated by the Policy will not be recognized pursuant to section 419A(g)(1).

Based on the above, we rule as follows:

1. M will not be taxed on any income from the Policy.

2. N will not be required to recognize any income on the account of the Policy.

3. Benefit payments under the policy to M will be excluded from M's gross income.

Final regulations pertaining to one or more of the issues addressed in this ruling letter have not yet been adopted. This ruling may be modified to the extent that final regulations are inconsistent herewith.

We are not ruling on the tax treatment of contract premiums under section 419(c) of the Code.

This ruling is based on the understanding that assets remaining upon cancellation of the Policy will be devoted to providing medical benefits for the Eligible Class of employees and retirees as originally intended

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

Because this letter could help resolve any future questions about M's exempt

status and unrelated trade or business activities, please keep a copy of this ruling in the organization's permanent records.

We are informing your District Director of this ruling.

Sincerely yours,

for/ by Robert Harper

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Branch 3