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

S.I.N. 0501.09-00 S.I.N. 419A.00-00 NO THIRD PARTY CONTACT
S.I.N. 0512.00-00 S.I.N. 4976.00-00

Date: MAR 10 2000

Contact Person:
XXXXXXXXXXXXXXXXX
ID Number:
XXXXXXXXX
Telephone Number:
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OP:E:EO:T3

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Employer Identification Number: XXXXXXXXXXXXXXXXX

Legend:

W = XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
X = XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P = XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P2 =
x =
y =

Dear Applicant:

By letter dated February 4, 1999, as modified and revised by letter dated May 6, 1999, X requested rulings under sections 111, 419A, 501, 512, 4976, and 6041 of the Internal Revenue Code concerning a proposed transaction. Specifically X requested the following rulings:

1. The partial dissolution of X and the distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will not adversely affect the exempt status of X under sections 501(a) and 501(c)(9) of the Code.

2. The distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will be a refund based on the experience of the entire fund within the meaning of section 419A(f)(5)(B)(ii) of the Code and will not affect the status of X as an employee-pay-all plan under section 419A(f)(5)(B).

3. The distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will not result in unrelated business taxable income within the meaning of section 512(a)(3)(A) of the Code.

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4. W will not be subject to the excise tax under section 4976 for provision of a disqualified benefit as a result of the partial dissolution of X and the distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses.

5. A retiree, or his or her surviving spouse, who receives a distribution from X pursuant to its partial dissolution will be required to include the distribution in gross income only to the extent that the retiree's Federal income tax was reduced by deduction of the contributions to X.

6. Distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses will not constitute fixed or determinable income subject to reporting by X or W under 6041(a).

Facts:

On October 7, 1992, W announced that it was terminating company-paid health care for retirees effective January 1, 1993. W established P, a new health care plan funded entirely by retirees. Benefits under P were provided on a self-insurance basis, through reimbursement of covered medical expenses, or through the payment of premiums for HMO coverage, where such coverage was elected by the retirees. P was funded by X, a trust. X was formed to provide health care benefits to certain W nonunion retirees and their dependents. X has been recognized as exempt under section 501(c)(9) of the Code. All contributions to X have been made by retirees. W has made no contributions to X. X states that approximately 17,000 retirees are participants in P.

Section 3.8 of X's trust indenture provides that all contributions to it and earnings thereon may not be used for any purpose other than providing health care benefits to the retirees and their dependents under P. Further, section 3.8 of X's trust indenture provides that, if the funds received by X exceed the amount actuarially necessary for satisfaction of all liabilities through 1996, additional life, sick, accident or other section 501(c)(9) benefits may by provided by P, or any other employee plan to retirees and their dependents.

To be covered by P, retirees had to pay a lump sum contribution to X of approximately $15x by January 1, 1993, for four years' coverage (1/1/93 to 12/31/96). Retirees who became eligible for P after January 1, 1993, paid a pro-rata amount of the lump-sum contribution. The amount paid was reduced by 1/48 for each month after January 1, 1993. Retirees were also required to pay monthly contributions to the Plan equal to those contributions made by active W employees. The lump sum and monthly contribution were actuarially determined to be sufficient for this 4-year period.

Effective January 1, 1997, W established P2. Under P2 the retirees may elect coverage under an HMO, a point-of service plan (POS) or an indemnity insurance plan where an HMO or POS plan is not available. Retirees are required to pay the full cost under P2.

At the time W was developing P2, it was expected that, after all claims for benefits during the 1993-96 period had been paid, there would be a surplus in X of approximately $43.9y. All claims for benefits during the 1993-96 period have now been paid and there is a surplus in X of

approximately $50.4 y, as of November 30, 1998. The retirees requested W to terminate the portion of X holding surplus funds attributed to the 1993-96 coverage period under P and to direct the Trustee to distribute these surplus funds to the retirees or to their surviving spouses.

Under sections 12.1 and 12.2 of X's trust agreement W reserved the right to terminate or amend any portion of the trust agreement. In the event of termination of the trust agreement, or of retiree health care benefits under P, W is empowered to direct the Trustee to dispose of all funds remaining after payment of all expenses.

W proposes to dissolve that portion of X holding surplus funds attributed to the 1993-96 coverage period under the Plan and direct the Trustee to distribute these funds to the retirees and their surviving spouses who were covered under the Plan. The amount of such surplus funds distributed to each retiree or surviving spouse will be in proportion to the lump sum contribution made by each retiree.

A retiree who contributed over the full 4-year period will receive 48 shares. A retiree who contributed for 47 months will receive 47 shares. A retiree who contributed for 46 months will receive 46 shares, and so on. Shares credited to each retiree and surviving spouse will be added together to determine the aggregate number of shares of retirees and surviving spouses. Shares will be credited only to retirees or surviving spouses who were alive as of a record date established by W. No shares will be credited to and no distribution will be made to any estate or heirs of any retiree or surviving spouse who was not alive as of the record date. Under this formula, each retiree and surviving spouse will receive a distribution of approximately $2.6x for 48 shares. This proposed method of distributing the surplus in exact proportion to the lump sum contributions is not precisely actuarially correct in that it ignores the extra interest that was earned on the lump sum contributions made earlier in, or at the start of, the 48 month period of coverage. Thus, if the surplus were to be divided taking into account the extra interest earned on earlier lump sum contributions, those retired at the start of the 48 month period would receive a slightly higher amount and those who retired at the end of the 48 month period would receive a slightly lower amount. In this situation, we believe these differences are not material.

Law:

Section 501(c)(9) of the Code provides for the exemption of voluntary employees' beneficiary associations that provide 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)-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 benefits permitted by section 1.501(c)(9)-3.

Section 1.501(c)(9)-4(c) of the regulations provides that "[t]he rebate of excess insurance premiums ... to the person ... whose contributions were applied to such premiums, does not constitute prohibited inurement...."

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Section 1.501(c)(9)-4(d) of the regulations provides, in part, that on termination of a plan, any assets remaining in the VEBA may be applied to provide, either directly or through the purchase of insurance, benefits within the meaning of section 1.501(c)(9)-3 of the regulations, 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 dissolution will not constitute prohibited inurement if the amounts distributed are determined on the basis of objective and reasonable standards which do not result in unequal payments to similarly situated members.

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b).

Section 512(a)(3)(B) of the Code defines, in pertinent part, the term "exempt function income" to mean the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also 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 paragraph (9), (17), or (20) of section 501(c), to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration. If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than such payments, such amount shall be included in unrelated business taxable income for the taxable year.

Section 512(a)(3)(E)(i) of the Code provides,in pertinent part, that in the case of an organization described in section 501(c) (9), 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 section 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).

Section 1.512(a)-5T, Q&A-3(b) of the regulations provides, in part, that the unrelated business taxable income of a VEBA for a taxable year of such organization generally will equal the lesser of two amounts: the income of the VEBA for the taxable year (excluding member contributions) or the excess of the total amount set aside as of the close of the taxable year (including member contributions and excluding certain assets with a useful life extending beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year.

Section 419(e) of the Code defines the term "welfare benefit fund" to include any organization described in section 501(c)(9) which is part of a plan of an employer and through which the plan provides any benefit other than a benefit with respect to which sections 83(h), 404, or 404A applies.

Section 419A(a) of the Code defines the term "qualified asset account" to mean any account consisting of assets set aside to provide for the payment of medical benefits, among others.

Section 419A(f)(5)(B) of the Code provides, in pertinent part that "no account limits shall apply in the case of any qualified asset account under a separate welfare benefit fund [under] (B) an employee pay-all plan under section 501(c)(9) if-

(i) such plan has at least 50 employees ..., and

(ii) no employee is entitled to a refund with respect to amounts in the fund, other than a refund based on the experience of the entire fund."

Section 61 of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. Section 1.61-1(a) of the regulations provides that gross income includes income realized in any form.

The tax benefit rule, which is of judicial origin and partially codified in section 111 of the Code, generally requires the recognition of gross income when a taxpayer properly claims a federal income tax deduction for an expense, derives a tax benefit from the deduction, and then receives a recovery of that expense in a subsequent year. Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983), 1983-1 C.B. 50. The recovery is includible in gross income to the extent of the tax benefit derived from the deduction in the prior year. See Rev. Rul. 93-75, 1993-2 C.B. 63.

Section 6041(a) of the Code provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits, and income of $600 or more in any taxable year shall render a true and accurate return to the Secretary of the Treasury, under such regulations and in such form and manner and to such extent as may be prescribed, setting forth the amount of such gains, profits and income, and the name and address of the recipient of such payment. Section 1 .6041-1(b) of the regulations provides that the term "all persons engaged in a trade or business" includes not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of profit, including an organization referred to in section 501(c) of the Code.

Section 1.6041-1(c) of the regulations provides that income is "fixed" when it is to be paid in amounts definitely predetermined, and is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.

As used in section 1.6041 of the regulations, the term "gains, profits and income" means gross income and not the gross amount paid. A payor is not required to make a return under section

6041 of the Code for payments that are not includible in the recipient's income, nor is a payor required to make a return if the payor does not have a basis to determine the amount of the payment that is required to be included in the recipient's gross income. See Rev. Rul. 80-22, 1980-1 C.B. 286, amplified by Rev. Rul. 82-93, 1982-1 C.B. 196.

Section 4976(a) of the Code imposes an excise tax in the amount of 100 percent of any disqualified benefit paid by a welfare benefit plan during any taxable year. The tax is imposed on the employer maintaining the welfare benefit plan.

Section 4976(b)(1) of the Code, defines the term "disqualified benefit" to mean (A) any post retirement medical benefit provided to a key employee that was not provided out of a separate account; (B) any post retirement medical benefit provided to an individual in whose favor discrimination is prohibited unless the plan meets the requirements of section 505(b) of the Code; and (C) any portion of a welfare benefit fund reverting to the benefit of an employer.

The committee reports on the Deficit Reduction Act of 1984, provide that a portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries.

(See H.R. Rep. No. 426, 99th Cong., Ist Sess. (1985), 1986-3 C.B. (Vol. 2) at 985. The Senate report on the 1986 changes includes a similar statement. S. Rep. No. 313, 99th Cong., 2d Sess. (1986), 1986-3 C.B. (Vol. 3) at 1009).

Rationale:

All P liabilities have been satisfied, and a substantial surplus remains in P. The accumulation of these funds was due primarily to favorable investment experience and lower health care inflation than was projected.

The excess funds remaining in P are the result of favorable investment experience and lower health care cost inflation than was projected. The amount to be distributed to members has been determined on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees. The amount to be distributed is substantially less than the amount originally paid by each retiree-participant and constitutes a partial return of premiums paid. Therefore, pursuant to sections 1.501(c)(9)-4(c) and (d) of the regulations, the proposed distribution will not adversely affect the status of X as an organization described in sections 501(a) and 501(c)(9) of the Code.

Because P was funded entirely by employee contributions and because W made no contributions to X on behalf of P, X is exclusively employee funded. Furthermore, because the amount of the surplus resulted from favorable investment experience and low health care inflation, the amount of the refund will constitute a refund based on the experience of the entire fund within the meaning of section 419A(f)(5)(B)(ii) of the Code. Accordingly, X is an employee pay-all plan within the meaning of section 419A(f)(5)(B) of the Code.

Because all contributions to X, including the net income earned thereon, have been used or set aside for the purpose of providing medical benefits to the participant-retirees and their dependents, as well as defraying reasonable administrative costs, such income is "exempt function income" within the meaning of section 512(a)(3)(B) of the Code. Since X is an employee pay-all plan within the meaning of section 419A(f)(5)(B) of the Code no account limits apply under section 419A(c). Thus, all of the contributions by retirees, and earnings thereon, constitute exempt function income under sections 512(a)(3)(B) and (E) of the Code and section 1.512(a)-5T, Q&A-3(b) of the regulations.

The distributions to retirees or their surviving spouses upon partial dissolution of X will not constitute inurement to the benefit of any private shareholder or individual prohibited by section 1.501(c)(9)-4 of the regulations. Such distributions will not result in any amounts set aside in X being used for any purpose other than the payment of permissible benefits and will therefore not constitute unrelated business taxable income under section 512(a)(3)(A) and (B) of the Code.

Since W has made no contributions to X, and since W will receive none of X's surplus funds, the distribution of the surplus fund to the retiree participants will not be a disqualified benefit within the meaning of section 4976(b) of the Code.

Section 213 of the Code allows an itemized deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152), to the extent such expenses exceed 7.5 percent of adjusted gross income. The Service has previously ruled, in general, that a retiree who elected to participate in the Plan and made a lump-sum payment to the Trust was entitled to deduct the payment under section 213.

If a retiree deducted his or her payment to the trust and the deduction reduced the amount of the retiree's federal income tax, the deduction would have resulted in a tax benefit to the retiree. The subsequent distribution from the Trust to the retiree (or a surviving spouse) would be a recovery of the payment to the Trust and would be included in gross income to the extent the deduction resulted in a prior tax benefit. However, the Trust cannot determine whether any retiree claimed an itemized deduction for the payment to the Trust or received a tax benefit from the deduction. Thus, the Trust cannot determine whether distributions will constitute gross income to retirees under the tax benefit rule. Therefore, distributions received by retirees (or surviving spouses) as a result of the partial dissolution of the Plan will not constitute fixed or determinable income for the purpose of information reporting, and are not subject to information reporting by the Trust under section 6041 of the Code.

Accordingly, based upon the information submitted, and assuming that you will operate in the manner represented, we rule that:

1. The partial dissolution of X and the distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will not adversely affect the exempt status of X under sections 501(a) and 501(c)(9) of the Code.

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2. The distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will be a refund based on the experience of the entire fund within the meaning of section 419A(f)(5)(B)(ii) of the Code and will not affect the status of the X as an employee-pay-all plan under section 419A(f)(5)(B).

3. The distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses in proportion to the lump sum contribution that each such retiree was required to pay to X will not result in unrelated business taxable income within the meaning of section 512(a)(3)(A) of the Code.

4. W will not be subject to the excise tax under section 4976 for provision of a disqualified benefit as a result of the partial dissolution of X and the distribution of X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses.

5. A retiree, or his or her surviving spouse, who receives a distribution from the X pursuant to its partial dissolution will be required to include the distribution in gross income only to the extent that the retiree's Federal income tax was reduced by deduction of the contributions to X.

6. Distribution of the X's surplus funds attributable to the 1993-96 coverage period under P to retirees or their surviving spouses will not constitute fixed or determinable income subject to reporting by X or W under 6041(a).

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

Sincerely yours,

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

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