

This is in reply to a letter dated June 28, 2004, and subsequent correspondence, requesting a ruling that the income of Trust is excluded from gross income under § 115(1) of the Internal Revenue Code.

FACTS

City proposes to establish a medical reimbursement plan (Plan). Plan provides reimbursement for health insurance premiums and out of pocket medical expenses incurred by certain retired employees and their spouses. Employees eligible to participate in Plan include employees employed by City on Date and certain former employees of City. No other employee is, or will become, eligible to participate in Plan. Plan benefits are provided in accordance with City's Employee Handbook. A City sponsored state law trust (Trust) will be established pursuant to Plan to fund the Plan benefits. City will make an initial contribution to Trust of \$x. No contributions will be made by employees or retirees. After the initial contribution no further contributions will be made by City.

City may elect to serve as the administrator of Plan. Alternately, City Council may choose to appoint a third party or a committee to serve as administrator. If the City Council appoints a committee, the committee shall consist of not less than three members. The administrator will interpret Plan and make all decisions regarding eligibility to participate in Plan and eligibility for Plan benefits. The committee may delegate to others all or part of its duties which do not involve the management of the Trust funds. The administrator appoints and removes the trustee. It directs the trustee with respect to investment, sale, reinvestment, and management of Trust funds. The administrator may also appoint one or more investment managers. The trustee will invest and reinvest Trust funds upon instructions from the administrator of Plan or the investment manager. The initial contribution to Trust, and the income derived from it, will be used for the exclusive purposes of providing benefits to participants under Plan and defraying reasonable expenses of administering Plan and Trust. The Plan documents require the trustee to confirm that all investments of Trust are lawful for a State municipality.

City may not terminate Plan until the Trust funds are exhausted, all possible benefits claims have been paid, or there are no longer any employee participants, retiree participants or eligible spouses. Upon termination of Trust, Trust funds shall be applied to pay any remaining debts, liabilities and approved claims of Plan. Any amount remaining shall be distributed to City.

LAW & ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides health benefits to former employees of City. City is a political subdivision of State. Providing health benefits to current or former employees constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of § 115(1) of the Code.

The income of Trust accrues to City. City is the sole participating employer in Plan. No private interests participate in or benefit from the operation of Trust. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74. Upon dissolution of Trust, the funds remaining in Trust will be applied to pay any remaining debts, liabilities and approved claims of Plan, and any amount remaining shall be distributed to City.

Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

Except as specifically provided above, this ruling expresses no opinion as to the federal tax consequences of any other transaction, including but not limited to, the tax consequences to participants, retirees, or their beneficiaries from any amounts contributed to or paid or reimbursed by or from Plan or Trust or as to compliance with COBRA continuation coverage requirements.

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

Sincerely,

David L. Marshall, Chief
Exempt Organizations, Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:

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