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Department of the Treasury

Washington, DC 20224

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Taxpayer =

Bargaining Unit VEBA =

Non-Bargaining VEBA =

year a =

year b =

year c =

x dollars = $

y dollars = $

z dollars = $

Dear

This is in response to your letter dated July 10, 2000, requesting rulings on behalf of Taxpayer regarding the application of the tax benefit rule and section 4976 of the Internal Revenue Code to the transaction described below.

FACTS

Taxpayer is a domestic corporation organized to construct, own, and operate an electric power generating plant. Taxpayer is subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC"). Taxpayer has two groups of employees: "bargaining unit employees" and "non-bargaining employees." Taxpayer provides life insurance and health insurance coverage to both active and retired employees.

Originally, Taxpayer accounted for such expenses on a “pay-as-you-go” basis. In year a, implementing a new accounting standard, Taxpayer began accruing amounts attributable to “post-employment benefits other than pensions” prior to the time the expenses were incurred; at the same time, FERC authorized Taxpayer to recover amounts attributable to both current and prior accruals from its ratepayers. An actuarial report was prepared for Taxpayer with respect to Taxpayer’s obligation to provide retiree benefits to both its bargaining unit employees and its non-bargaining employees.

In order to receive the amounts recovered from its ratepayers, Taxpayer established trusts under two voluntary employee benefits associations (VEBAs): Bargaining Unit VEBA and Non-Bargaining VEBA. Although the trusts contain amounts for payment of both active and retiree benefits, the respective trust agreements require amounts contributed for payment of retiree benefits to be separately accounted for and used solely for that purpose. Taxpayer represents that the Non-Bargaining VEBA does not fund benefits for any of its employees who are classified as “key employees” within the meaning of section 416(i) of the Code. Taxpayer represents that the Bargaining Unit VEBA is maintained pursuant to a collective bargaining agreement within the meaning of the term in section 419A(f)(5)(A) of the Code.

For the years a through b, Company contributed to the Non-Bargaining VEBA the amounts it received from its ratepayers for the active and retiree benefits for the non-bargaining employees. The total amount contributed for the non-bargaining retiree benefits was x dollars. Taxpayer represents that it calculated and took deductions on its corporate return based on the account limit requirements of section 419A(c) of the Code. The total amount of the deductions taken for those years was y dollars, an amount less than the actual contributions.

For the years a through b, Company contributed to the Bargaining Unit VEBA the total amount it received from its ratepayers for the active and retiree benefits for the bargaining unit employees. The total amount contributed for the bargaining unit retiree benefits was z dollars. Taxpayer took deductions on its corporate return for the full amount of the contributions in the taxable year in which the contributions were made.

Due to unexpectedly high investment returns, the amount of assets contained in the Non-Bargaining VEBA and allocated for payment of the non-bargaining retiree benefits now substantially exceeds the present value of Taxpayer’s expected future obligations with respect to providing such benefits. Similarly, the amount of assets contained in the Bargaining Unit VEBA and allocated for payment of the bargaining unit retiree benefits now substantially exceeds the present value of Taxpayer’s expected future obligations with respect to providing such benefits. An actuarial report has been prepared on behalf of Taxpayer with respect to the overfunding. The amount of overfunding for the Non-Bargaining VEBA was calculated by subtracting Taxpayer’s expected future obligation to provide retiree benefits to its non-bargaining unit employees from the total assets contained in the Non-Bargaining VEBA and allocated

for the provision of retiree benefits. A similar calculation of the overfunded amount was made for the Bargaining Unit VEBA. As of January 1 of year c, the overfunded amount for the Non-Bargaining VEBA is less than the difference between Taxpayer's total contributions to that VEBA for retiree benefits and the total deductions taken by Taxpayer for such contributions. The overfunded amounts of both VEBAs are to be recalculated annually.

Taxpayer now proposes to use a portion of the overfunded amount in the Non-Bargaining VEBA and the Bargaining Unit VEBA to pay for health and welfare claims and expenses for its active non-bargaining unit employees and its active bargaining unit employees, respectively. To do this, the Taxpayer proposes to amend the provisions of the trust agreements to provide that the Non-Bargaining overfunded amount and the Bargaining Unit overfunded amount, respectively, determined as of the beginning of each year, may be used during that year for the payment of health and welfare claims and expenses for the active non-bargaining unit and the active bargaining unit employees. In addition, Taxpayer has represented that it will receive approval from FERC prior to the use of the overfunded amounts for benefits for the active employees.

With respect to the Non-Bargaining VEBA, Taxpayer proposes to pay for the benefits for the active non-bargaining unit employees only from that portion of the overfunded amount attributable to contributions for which Taxpayer has not taken a deduction under section 419 of the Code. More specifically, Taxpayer will not pay for health and welfare claims and expenses for active non-bargaining unit employees from that portion, if any, of the overfunded amount held by the Non-Bargaining VEBA consisting of contributions for which a deduction has already been taken under section 419 (or will be taken for the current taxable year), nor will it pay such claims and expenses from any earnings that have accumulated on that portion. For this purpose, Taxpayer will assume that all contributions allocated to the separate account for retiree benefits for which it has already taken (or will take in the current taxable year) a deduction under section 419, and earnings thereon, are allocated and used first to pay for the retiree benefits, and therefore that all amounts attributable to contributions for which Taxpayer has not taken a deduction under section 419 are allocable first to the overfunded amount.

RULINGS REQUESTED

You have requested rulings that the proposed transaction will not cause Taxpayer to recognize any taxable income under the tax benefit rule and that it will not cause Taxpayer to incur excise tax under section 4976 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.

Section 111(a) of the Code provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by Chapter 1 of the Code. That section, in part, codifies the "tax benefit rule". Generally, the tax benefit rule requires the inclusion in income of certain amounts that were deducted in a prior year and that generated a tax benefit through a reduction in the amount of tax liability in the prior tax year. *Estate of Block v. Comm'r, 39 B.T.A. 338 (1939),* aff'd sub nom. *Union Trust Co. v. Comm'r, 111 F.2d 60 (7th Cir. 1939),* cert. denied, *311 U.S. 658 (1940); Rev. Rul. 85-186, 1985-2 C.B. 84.* In *Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983),* the Supreme Court held, in part, that income may arise under the tax benefit rule even though there is no actual recovery of funds that were previously deducted, if an event occurs that is "fundamentally inconsistent" with the premise on which a deduction was taken in a prior year.

Section 419 of the Code provides rules with respect to the tax treatment of "welfare benefit funds." Section 419(e)(1) 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.

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 be deductible under section 419 for the taxable year in which paid, but subject to the limitation of section 419(b).

Section 419(b) of the Code provides that the amount of the deduction for any taxable year shall not exceed the welfare benefit fund's "qualified cost" for the taxable year. Under section 419(c)(1), the term "qualified cost" means, with respect to any taxable year, the sum of (A) the "qualified direct cost" for such taxable year, and (B) subject to the limitation of section 419A(b), any addition to a "qualified asset account" for the taxable year, reduced by the fund's after-tax income for the taxable year.

Section 419(c)(3) of the Code defines "qualified direct cost" to mean, 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 (i) such benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting.

Section 419(d) of the Code provides that if the amount of the contributions paid by the employer during any taxable year to a welfare benefit fund exceeds the limitations of section 419(b), the excess shall be treated as an amount paid by the employer to such fund during the succeeding taxable year.

Section 419A(a) of the Code defines "qualified asset account" to mean any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, 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)(B) to the extent such addition results in the amount in that account exceeding the "account limit." Pursuant to section 419A(c)(1), except as otherwise provided in that subsection, the "account limit" for any "qualified asset account" for any taxable year is the amount reasonably and actuarially necessary to fund (A) claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in subsection (a) of section 419A, and (B) administrative costs with respect to such claims.

Section 419A(c)(2) 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 (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees.

Section 419A(f)(5)(A) of the Code provides that no account limit shall apply in the case of any qualified asset account under a separate welfare benefit fund established pursuant to a collective bargaining agreement.

Section 1.419A-2T, Q&A-2, of the regulations provides that contributions to a welfare benefit fund maintained pursuant to one or more collective bargaining agreements and the reserves of such a fund generally are subject to the rules of section 419, 419A, and 512. However, neither contributions to nor reserves of such collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until a specified time after final regulations concerning limits for collectively bargained plans are issued. No final regulations have yet been issued.

Section 4976(a) of the Code imposes an excise tax on an employer equal to 100% of any disqualified benefit provided by an employer-maintained welfare benefit fund.

Section 4976(b)(1)(C) of the Code provides that the term "disqualified benefit" includes 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) shall not apply to any amount attributable to a contribution to a welfare benefit fund that is not allowable as a deduction under section 419 for the taxable year or any prior taxable year (and that contribution shall not be included in any carryover under section 419(d)).

The proposed transaction for the Bargaining Unit VEBA involves paying for the benefits for the active bargaining unit employees from amounts attributable to

contributions for which Taxpayer has previously taken a deduction pursuant to section 419A(f)(5)(A) of the Code. As stated above, the tax benefit rule is implicated when a taxpayer has taken a deduction in a prior year, and in a subsequent year an event occurs that is fundamentally inconsistent with the premise of the deduction. The rule protects the Government and taxpayers from the adverse effects of reporting a transaction on the basis of assumptions that an unforeseen event in a subsequent year proves to have been erroneous. However, not every unforeseen event will require the taxpayer to report income in the amount of the prior deduction. Rather, the tax benefit rule will "cancel out" a prior deduction only when the subsequent event is indeed "fundamentally inconsistent with the premise on which the deduction was based. That is, if that event had occurred within the same taxable year [as the deduction], it would have foreclosed the deduction." Hillsboro, 460 U.S. at 383-84 [footnote omitted]. The facts and circumstances of each case must be considered "in light of the purpose and function of the provisions granting the deductions." Id. at 385.

In computing Taxpayer's deduction for contributions to the Bargaining Unit VEBA, those contributions are not treated as exceeding the qualified cost limitation of section 419(b) of the Code. As a result, if the proposed transaction had occurred within the same taxable year as the deduction, the deduction would not have been foreclosed. Thus, the proposed transaction is not fundamentally inconsistent with the premise on which the deduction was based, and the tax benefit rule does not require Taxpayer to include any amounts in income as a result of use of the Bargaining Unit VEBA's overfunded amount being used to provide medical and life insurance benefits to the active bargaining unit employees.

Further, the proposed transaction for the Bargaining Unit VEBA will not result in an excise tax under section 4976 of the Code. The proposed transaction for the Bargaining Unit VEBA solely involves using assets set aside for the payment of collectively bargained post-retirement health and welfare benefits instead for the payment of collectively bargained health and welfare benefits for active employees. Under these circumstances, there is no reason to view the proposed transaction as a reversion to the employer for purposes of the tax imposed by section 4976 of the Code since excess assets will continue to be used for the payment of collectively-bargained-for qualifying benefits.

The proposed transaction for the Non-Bargaining VEBA involves paying for the benefits for the active non-bargaining unit employees only from that portion of the overfunded amounts attributable to contributions for which Taxpayer has not yet taken a deduction. The tax benefit rule and section 111 of the Code are irrelevant to the proposed transaction involving the Non-Bargaining VEBA. The proposed use of amounts in the Non-Bargaining VEBA cannot be fundamentally inconsistent with the premise on which a deduction was taken in a prior year because no deduction with respect to the amounts to be used was ever taken. Therefore, the proposed transaction should not result in the realization or recognition of gross income by Taxpayer under section 61.

Further, the proposed transaction for the Non-Bargaining VEBA will not result in an excise tax under section 4976 of the Code. A payment that reverts to the benefit of an employer is not a disqualified benefit under section 4976 to the extent it is attributable to an employer contribution with respect to which no deduction is allowable under section 419 for the current or any prior taxable year. Section 4976(b)(3) of the Code. The amounts allocated to post-retirement benefits that will be used instead for benefits for the active non-bargaining unit employees will consist only of amounts attributable to contributions for which no deduction is allowable for the current year or a prior year under section 419 of the Code. These amounts will therefore not be treated as reverting to the benefit of the employer for purposes of section 4976 of the Code.

Based on the information submitted, and the representations made therein, we rule as follows:

(1) The proposed transactions will not result in income to Taxpayer under the tax benefit rule.

(2) The proposed transactions will not cause Taxpayer to incur an excise tax under section 4976 of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(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 whether the welfare benefit fund was established pursuant to a collective bargaining agreement, nor about whether any previous deductions taken by Taxpayer were allowable.

Sincerely,
MARK SCHWIMMER
Senior Technical Reviewer
Division Counsel/Associate Chief Counsel
(Tax Exempt and Governmental Entities)

Enclosures:
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