Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:

November 29, 2001

Dear:

This is in response to your letter of August 21, 2001, in which you requested various rulings on behalf of the Program.

The Program is a multi-employer insurance program established by State pursuant to legislative mandate covering active and retired government employees. The purpose of the Program is to reimburse cancer-stricken active and retired firefighters for specific medical expenses they have incurred as a result of their cancer.

Participants in the Program include State and political subdivisions of State that employ firefighters and that participate in the public safety personnel retirement system (established under State law). These employers are required by statute to participate in the Program.

The Program is administered by and is under the exclusive control of the fund manager, which is a State agency. The fund manager contracts for a group cancer insurance policy or may self-insure to provide the coverage required under the Program. The duties and authority of the fund manager are designated by statute.

The fund manager of the Program is, by statute, the same body that is the fund manager for the public safety retirement system. The fund manager of the public safety personnel retirement system consists of five members each of whom is appointed by the State's governor in accordance with State law. The consent of the Senate is required for each of the governor's appointments to the fund manager.

The Program is funded in its entirety by annual premiums paid by the State and political subdivision employers that participate in the Program. The fund manager deposits the premiums for the Program into a segregated account to pay both the cost of benefits and Program administration.

Each year, the fund manager causes an independent audit of the account to be performed with the results reported to all participating employers. Coverage under the Program may be cancelled, changed or terminated by the fund manager at any time without notice. If the Program is terminated, the fund manager must refund the monies in the Program account on a pro rata basis to employers, except for monies held in reserve for benefits as determined by the fund manager.

Under the State's "sunset law", the State legislature has scheduled the fund manager for termination on July 1, 2006. If the fund manager is terminated, the Program will terminate as well, because the fund manager is the exclusive agency authorized to administer the Program and the Program's account under the statute.

The enabling legislation for the Program states that, for the purposes of the Internal Revenue Code (the Code), the Program is an integral part of a political subdivision of the State. The statute also provides that the Program's income is intended to be excludable under section 115 of the Code and that coverage under the Program is intended to be excludable from employees' and retirees' gross income under section 106 of the Code.

You have requested the following rulings on behalf of the Program:

1) All income of the Program is exempt from federal income tax under the doctrine of intergovernmental immunity on the grounds that the Program is a political subdivision of the State or an integral part of one or more political subdivisions.

2) In the alternative, if the Program is not a political subdivision of the State or an integral part of one or more political subdivisions of the State, the income of the Program is exempt from federal income tax under section 115(1) of the Code.

3) All premiums paid to the Program by its participating governmental employers are excludable from the gross income of the participating employees and retirees under section 106 of the Code.

Issue One:

In general, if income is earned by an enterprise that is an integral part of a state or a political subdivision of a state, that income is not taxable in the absence of specific statutory authorization to tax that income. See Rev. Rul. 87-2, 1987-1 C.B. 18; Section 511(a)(2)(B) of the Code; Rev. Rul. 71-131, 1971-1 C.B. 28. In contrast, when a state conducts an enterprise through a separate entity, the income of the entity may be excluded from gross income under section 115.

In Maryland Savings-Share Insurance Corp. ("MSSIC") v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan

associations. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim of intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Although the district court was reversed on other grounds, the Supreme Court agreed with the lower court's analysis of the instrumentality and section 115 issues. The Supreme Court rejected MSSIC's position that "it is an instrumentality of the State and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity and under section 115 of the Code." MSSIC, 400 U.S. at 7, n.2. See also, State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992).

In determining whether an enterprise is an integral part of the state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise. If an enterprise is deemed to be an integral part of a state or political subdivision of a state, that enterprise will not be treated as a separate entity for federal tax purposes, regardless of the fact that the enterprise was created as a separate entity. Section 301.7701-1(a)(3) of the Income Tax Regulations.

With respect to whether the State or a political subdivision exerts significant control and influence over the Program, the facts show that the State does exert such control and influence. The creation of the Program was mandated by State legislation. The Program was established by the fund manager, which has exclusive control of the Program. The fund manager is a State agency and consists of five members who are appointed by the State's governor with the consent of the State Senate. The fund manager may cancel, change or terminate coverage under the Program at any time without notice. Finally, the State legislature has retained the power to terminate the fund manager, on July 1, 2006, should it so choose, through the use of a statutory "sunset law." If the fund manager is terminated, the Program also would terminate, because the fund manager is the exclusive agency authorized to administer the Program and the Program's account under the statute.

The following facts also demonstrate that the State, as well as political subdivisions of the State, have made a substantial financial commitment to the Program. The Program is funded completely by the State and political subdivisions of the State. The State legislature has mandated that each employer is required to participate in the Program (i.e., the State and any political subdivision of the State that employ firefighters and that participate in the public safety personnel retirement system) and fund a portion of the Program in an amount set by statute. Additionally, monies collected for the Program are deposited by the fund manager into an account to pay the cost of providing benefits and administering the Program. Each year, the fund manager causes an independent audit of the account to be performed with results reported to all participating employers. Finally, if the Program is terminated, the fund manager must refund monies in the

Program account on a pro-rata basis to the State and political subdivisions, except for monies held in reserve for benefits as determined by the fund manager.

Accordingly, the Program is an integral part of the State and of political subdivisions of the State. As a result, all income of the Program is exempt from federal income tax.

Issue Two:

Because the Program is an integral part of the State and of political subdivisions of the State, we do not consider the application of section 115(1) of the Code to the Program.

Issue Three:

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived, including compensation for services.

Section 106(a) of the Code provides that except as otherwise provided in that section, gross income of an employee does not include employer-provided coverage under an accident and health plan.

Section 1.106-1(a) of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust fund (including a fund referred to in section 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if such insurance policy, trust, or fund, provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits.

Rev. Rul. 62-199, 1962-2 C.B. 32, states that the exclusion under section 106 is applicable to amounts paid for the benefit of retired employees as well as current employees.

Payments for the cost of the cancer insurance benefit qualifies as payments for accident and health coverage. Accordingly, premiums paid by governmental employers are excludable from the participants' gross income under section 106 of the Code.

Based on the information submitted, representations made and authorities cited above,

we conclude as follows:

(1) The Program is exempt from all federal income tax because it is an integral part of the State and of one or more political subdivisions of the State. The Program is not required to file an annual federal income tax return.

(2) No ruling is given with respect to section 115(1) of the Code.

(3) Premiums paid to the Program by the participating governmental employers are excludable from the gross income of employees and retirees under section 106 of the Code.

Except as specifically ruled upon above, no opinion is expressed or implied with respect to the application of any other provisions of the Code or the regulations to the benefit described.

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

Sincerely,
Harry Beker
Chief, Health and Welfare Branch
Office of Division Counsel/
Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:
Copy of this letter
Copy for section 6110 purposes