Internal Revenue Service

Number: **200704005**
Release Date: 1/26/2007
Index Number: 106.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
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Refer Reply To:
CC:TEGE:EB:HW
PLR-114668-06
Date: October 27, 2007

Legend

Taxpayer =

Plan =

State =

Dear :

This is in reply to your letter dated February 16, 2006, in which you request a ruling on behalf of Taxpayer.

Taxpayer is a governmental entity and political subdivision of State. Taxpayer proposes to adopt the Plan to allow eligible employees to elect to have contributions made to the Plan in lieu of regular compensation or accrued leave, or both, to pay for medical expenses after retirement.

As proposed, Taxpayer's employees will have the option to have contributions made to the Plan in lieu of receiving a portion of regular compensation or accrued leave, or both. Contributions will be pursuant to an election. Once the election is made, the Plan provides that the election is irrevocable; it cannot be reversed or revoked by the employee, and the employee cannot receive cash refunds of the contributions.

Employees will have 30 days from initial eligibility within which to make a one-time irrevocable election to participate in the Plan. Employees who have not previously elected to participate will have an annual period of 30-60 days in which to make a one-time irrevocable election.

Taxpayer contributions of regular compensation, pursuant to the employee's election, will begin either on the first day of the month following the initial 30-day election period or the first day of the calendar year following the annual 30-60-day election period. Taxpayer contributions of the value of accrued leave to the Plan, pursuant to an employee's election, will be made after the election upon termination of the employee's employment with Taxpayer.

Employees will be permitted to irrevocably elect to have Taxpayer contribute a percentage of their regular compensation to the Plan. Such contribution will reduce compensation otherwise payable to the employees. The value of accrued leave, up to a total of 500 hours, will be permitted to be made to the Plan. All contributions will be fully vested at all times, and held in trust by Plan.

Retirees who participate in Plan will be able to use their accounts only to pay for medical expenses described in section 213(d) of the Internal Revenue Code (the Code), except for long term care expenses. Plan allows amounts remaining after a participant's death to be available for use by the surviving spouse, dependents or other beneficiaries.

Section 61(a)(1) provides that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. Section 1.61-21(a)(3) and (4) of the Income Tax Regulations state that a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation to the person performing such services.

Section 106 of the Code provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the regulations provides that the gross income of an employee does not include contributions which the employee's employer makes to an accident or health plan for compensation (through insurance or otherwise) for personal injuries or sickness to the employee or the employee's spouse or dependents.

Part I of Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of health reimbursement arrangements (HRAs). The notice explains that a tax-favored HRA is an arrangement that (1) is paid for solely by the employer and not pursuant to a salary reduction election or otherwise under a section 125 cafeteria plan; (2) reimburses the employee for medical care expenses (as defined in section 213(d)) incurred by the employee or by the employee's spouse or dependents; and (3) provides

reimbursements up to a maximum dollar amount with any unused portion of that amount at the end of the coverage period carried forward to subsequent coverage periods.

Part IV of Notice 2002-45 emphasizes that employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a section 125 cafeteria plan. An accident and health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under section 125. See also, Rev. Rul. 2002-41, 2002-2 C.B. 75; Rev. Rul. 2005-24, 2005-1 C.B. 892; Rev. Rul. 2006-36, 2006-36 I.R.B. 353. Under section 125, unused contributions at the end of a coverage period may generally not be carried forward and used in subsequent coverage periods.

Rev. Rul. 75-539, 1975-2 C.B. 45, describes two labor contracts. Contract A provides that upon retirement, an employee will receive a portion of accumulated unused sick leave credits as a cash payment or, at the election of the employee, the payment may be applied to continue the employee's participation in the employer's health plan. Contract B provides that the value of a portion of the accumulated unused sick leave credits will be used to pay for continued participation in the employer's health plan.

Rev. Rul. 75-539 holds that, under Contract A, the value of unused accumulated sick leave credits used to continue health coverage is constructively received by the retired employee under section 451 of the Code, and therefore is includible in the retired employee's gross income. Under Contract A, the amount of the premium payments is considered an employee contribution out of salary and not a contribution by the employer under section 106 of the Code. However, under Contract B, the value of unused accumulated sick leave credits, which may not be received in cash, is not constructively received by the retired employee, but is a contribution by the employer to the employer's health plan that is excludable from the retired employee's gross income under section 106 of the Code.

Rev. Rul 2005-24 describes a health reimbursement arrangement. Situation 1 of the ruling states that when an employee retires, the employer automatically and on a mandatory basis (as determined under the Plan) contributes an amount to the reimbursement plan equal to the value of all or a portion of the retired employee's accumulated unused vacation and sick leave. Relying on Rev. Rul. 75-539, the ruling concludes that the reimbursement plan described in Situation 1 is an HRA that meets the requirements for tax-favored treatment.

Rev. Rul. 2006-36 describes a health reimbursement arrangement. Under the arrangement, unused reimbursement amounts are paid as reimbursement of the substantiated medical care expenses of a beneficiary designated by the employee (other than the spouse and dependents of the employee). The ruling holds that amounts paid under the reimbursement arrangement are not excludable from gross income. Rev. Rul. 2006-36 is effective for plan years beginning after December 31, 2008.

Based on the representations made and authorities cited above, we conclude that, pursuant to employees' elections, contributions that are made to the Plan in lieu of employees receiving a portion of their regular compensation or accrued leave, or both, are not excludable from employees' gross income under section 106 of the Code. Contributions to the Plan are includable in employees' gross income under section 61 of the Code.

No opinion is expressed as to the federal tax consequences of the transaction under any other section of the Code or statute other than those specifically stated above.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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