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April 22, 1999

Taxpayer =

Dear

This is in reply to your letter dated December 9, 1998, requesting rulings on behalf of Taxpayer, concerning the federal income tax treatment of certain long-term disability plans under sections 104 and 105 of the Internal Revenue Code (the Code).

It is represented that Taxpayer is a voluntary employees' beneficiary association qualified under section 501(c)(9) of the Code. Taxpayer currently provides member local school district employees with long-term disability coverage under various plans. Long-term disability coverage provided to school district employees (i.e., participants) is negotiated and agreed upon by bargaining representatives and the member local school districts. This coverage is then included as a contractual term in the collective bargaining agreements entered into by the parties. Under most of the long-term disability plans, employees who become disabled receive benefits equal to 66 2/3 percent of normal salary. Currently all of the Taxpayer's long-term disability plans require that each employer pay all long-term disability plan insurance premiums for each respective participant.

In the future, many local school district collective bargaining agreements will contain language modifying current long-term disability plans offered by Taxpayer, or requiring that new plans be structured in one of the following two ways:

Option A provides that some collective bargaining agreements will require employers to discontinue paying for each participant's long-term disability plan coverage and provide that each participant will purchase his or her own long-term disability plan coverage with after-tax dollars. The collective bargaining agreements will provide that each employer will purchase long-term disability plan coverage on behalf of each participant and then reimburse itself by deducting all costs related to the long-term disability plan coverage directly from the participant's after-tax take-home pay through payroll deductions. To

compensate each participant for the loss of this previously employer-paid coverage, some bargaining representatives will ask employers to provide each participant with a one-time salary increase equal to either (a) the annual cost of the participant's long-term disability coverage, or (b) the annual cost of that participant's long-term disability coverage plus the estimated additional individual income tax related to the one-time salary increase.

Option B provides that some collective bargaining agreements are expected to require that each employer continue paying for each participant's long-term disability plan coverage "on behalf of" each participant acting as a "conduit" and that the amounts paid by the employer for each participant's long-term disability plan coverage will be added to each participant's gross income in the pay period the payments are made by the employer. Under this plan, each participant may receive a one-time salary increase equal to the estimated additional tax associated with the inclusion in income of the amounts paid for the participant's long-term disability plan coverage.

Section 104(a)(3) of the Code provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer).

Section 1.104-1(d) of the Income Tax Regulations states that if an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees, the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. The regulation refers to section 1.105-1 of the regulations for rules relating to the determination of the amount attributable to employer contributions.

Amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in gross income under section 105(a) of the Code to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 1.105-1(c)(1) of the regulations provides that in the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105(a) of the Code applies to the extent that such payments are attributable to contributions of the employer that were not includible in the employee's gross income. A separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in

any case where the plan provides that some classes of covered employees contribute but others do not or that different classes of employees will make different contributions, and where, in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with section 1.105-1(d) in the case of insured plans.

Section 1.105-1(d)(2) of the regulations provides that if accident or health coverage is provided under or is a part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year, bears to the total of the net premiums contributed by the employer and all employees for such policy years. If the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year. If the net premiums for such coverage are not known at the beginning of the calendar year for even one policy year, such determination shall be made by using either (i) a reasonable estimate of the net premiums for the first policy year, or (ii) if the net premiums for a policy year are ascertained during the calendar year, by using such net premiums.

In Bouquet v. Commissioner, T.C. Memo. 1994-212, the taxpayer's employer paid the premium for long-term disability insurance and the taxpayer reimbursed his employer. The insurance policy stated that the employer was "nothing more than an agent or conduit which paid the premiums nominally and then collected the premium payments from the employees themselves." In addition, the employees signed agreements to recompense the corporation for these disbursements. The court in Bouquet concluded that the disability benefits received by the taxpayer were attributable to employee contributions and were thus excludable from the taxpayer's gross income under section 104(a)(3) of the Code.

In the instant case, employees covered by collective bargaining agreements which adopt either Option A or Option B will have long-term disability benfits that are attributable to contributions by the employer which will be includible in the gross income of participants, or participants will pay for the long-term disability coverage with after-tax dollars.

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

(1) Long-term disability coverage purchased under Option A or Option B will be attributable to employee contributions for purposes of section 104(a)(3) of the Code. Accordingly, assuming that the employees subject to the collective bargaining agreement

can be treated as a separate class of employees under section 1.105-1(c) of the regulations, long-term disability benefits received by participants in new plans created pursuant to Option A or Option B will be excludable from the participants' gross income under section 104(a)(3) of the Code.

(2) With respect to existing long-term disability plans which are merely modified pursuant to Option A or Option B, the percentage of disability benefits received by participants that is included in gross income under section 105(a) will be calculated in accordance with section 1.105-1(d)(2) of the regulations. If both the contributions of the employer and the contributions of the employees subject to a collective bargaining agreement can be ascertained, then the employees subject to that collective bargaining agreement will be considered a separate class of employees for purposes of this calculation.

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

Sincerely yours,

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Harry Beker
Chief, Branch No.6
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosures:
Copy of this letter
Copy for section 6110 purposes