

January 18, 2007

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VIA E-MAIL AND FEDERAL EXPRESS

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RE: IRS Notice 2007-7, Q&A—23

Dear Gentlemen:

We are writing to you in regard to IRS Notice 2007-7, the recently issued guidance on the Pension Protection Act of 2006 ("PPA"), and as a follow-up to a telephone conference we had with Mr. Reeder this week. While we welcome the helpful explanations on many aspects of the PPA, we have significant concerns regarding one portion of the guidance issued on the interpretation of Section 845 of the PPA. As you know, that Section provides a \$3,000 income tax exclusion for eligible retired public safety officers who elect to use a portion of their distribution from an eligible retirement plan to directly pay for qualified health insurance premiums.

Specifically, Q&A-23, as written, appears to define the term "accident or health insurance plan" in a very restrictive manner. One unfortunate result of this interpretation may be to deny this important tax benefit to a significant number of retired public safety officers who would otherwise be entitled to receive it. In this letter, we have outlined what we believe to be the relevant legal framework for this issue and proposed an alternative interpretation for the Internal Revenue Service ("Service" or "IRS") and the Treasury Department to adopt.

As background, the Employee Benefits Group of Ice Miller provides counsel to a wide variety of public sector plans. In particular, we represent over twenty-five state-wide public retirement systems across the country, as well as numerous single-employer governmental systems, including a substantial number of plans covering public safety employees. Many of these systems also administer health plans.

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Our comments below are based on our experience with these public safety pension and health plans, and reflect the significant concerns being raised within that group regarding the guidance included in IRS Notice 2007-7. Please know that these plans are expending considerable resources and efforts to fulfill the requirements of PPA Section 845. In some cases, this involves significant programming, redrafting forms, and educating members and employers. It may also involve new data information links and feeds between employers (generally states, citizens, towns and counties) and the pension systems. Despite these burdens, these systems are committed to providing the \$3,000 exclusion to their public safety members.

BACKGROUND AND PPA § 845

Public safety unions have been engaged in a multi-year effort to provide their retired members with the opportunity to continue pre-tax deductions for health care premiums, which they had as active members. Those efforts came to fruition with the passage of the HELPS program in Section 845 of the PPA (adding Code Section 402(l)). This section provides in pertinent part as follows:

(l) DISTRIBUTIONS FROM GOVERNMENTAL PLANS FOR HEALTH AND LONG-TERM CARE INSURANCE.

(1) IN GENERAL. In the case of an employee who is an eligible retired public safety officer who makes the election described in paragraph (6) with respect to any taxable year of such employee, gross income of such employee for such taxable year does not include any distribution from an eligible retirement plan to the extent that the aggregate amount of such distributions does not exceed the amount paid by such employee for qualified health insurance premiums of the employee, his spouse, or dependents (as defined in section 152) for such taxable year.

(4) DEFINITIONS. For purposes of this subsection—

(D) QUALIFIED HEALTH INSURANCE PREMIUMS. The term “qualified health insurance premiums” means premiums for coverage for the eligible retired public safety officer, his spouse, and dependents, by an accident or health insurance plan or qualified long-term care insurance contract (as defined in section 7702B(b)).

(5) SPECIAL RULES. For purposes of this subsection—

(A) DIRECT PAYMENT TO INSURER REQUIRED. Paragraph (1) shall only apply to a distribution if payment of the premiums is made directly to the provider of the accident or health insurance plan or qualified long-term care insurance contract by deduction from a distribution from the eligible retirement plan.

Code Section 402(l) (emphasis added).

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Q&A-23

IRS Notice 2007-7 included a series of Q&As regarding implementation of new Code Section 402(l). Our particular concern relates to Q&A-23, which provides as follows:

Q-23. Can the accident or health plan receiving the payments of qualified health insurance premiums be a self-insured plan?

A-23. No. The accident or health plan must be an accident or health insurance plan. Thus, the plan must be providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).

OUR POSITION

We do not believe the answer is the best reading of the PPA, its legislative history or the most logical parallel to existing IRS guidance. Specifically, we do not understand the basis for requiring that, in order to be an "accident or health insurance plan," the "plan must be providing insurance issued by an insurance company regulated by a State." Based upon our conversation with Tom Reeder, we believe this statement could exclude state regulated governmental self-insurance plans, as well as other governmental health plans that are not insured. As discussed below, the relevant Code Sections and Treasury Regulations relating to the tax treatment to be accorded to accident or health plans have consistently treated both fully-insured and self-insured plans in the same manner. We believe there is no support for treating these types of health plans differently, and doing so will result in denying this tax benefit to a substantial number of eligible retired public safety officers who would otherwise be entitled to receive it.

1. Legislative History

The legislative history to Section 845 of the PPA does not provide any indication that Congress intended to provide this exclusion only to retirees covered by health plans or policies offered by insurance companies, as opposed to also including retirees with health coverage under any accident or health insurance plan, including a self-insured plan offered by an employer:

The bill provides that certain pension distributions from an eligible retirement plan used to pay for qualified health insurance premiums are excludible from income, up to a maximum exclusion of \$3,000 annually....

Qualified health insurance premiums include premiums for accident or health insurance or qualified long-term care insurance contracts covering the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The qualified health insurance premiums do not have to be for a plan sponsored by the employer; however, the exclusion does not apply to premiums paid by the employee and reimbursed with pension distributions. Amounts excluded from income under the provision are not taken into account in determining the itemized deduction for medical expenses under section 213 or the deduction for health insurance of self-employed individuals under section 162.

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Joint Committee on Taxation Technical Explanation ("JCT Explanation") to PPA Section 845.

Thus, we think the legislative history would support the most common usage of the phrase "accident or health insurance."

2. Internal Revenue Code and Regulation Provisions

Code Section 402(l) (PPA Section 845) uses the phrase "accident or health insurance" plan without a cross-reference to any definition of that term. We believe the most appropriate place to seek a complete definition is Internal Revenue Code Sections 104 and 105. Those sections govern the treatment of certain amounts received through "accident or health insurance" for personal injuries or sickness. Code Section 104 governs the tax treatment of benefits paid through accident or health insurance for injuries or sickness other than employer provided coverage, and Code Section 105 governs the tax treatment of benefits paid through accident or health insurance for injuries or sickness through accident or health insurance provided by the employer. Thus, since we believe the intent of PPA Section 845 was to cover both employer-based coverage, as well as individual-based coverage (as indicated in the JCT Explanation), it is appropriate to review the terms used in both sections. Both sections and their related regulations lead to the conclusion that both insurance and self-insurance are included within the term "accident or health insurance." We have emphasized Section 105 because the clients that we represent are primarily concerned with employer-provided accident and health insurance. However, we have also included Section 104 because PPA Section 845 covers individually secured products and because we believe Section 105 and Section 104 present a clear, consistent picture.

3. Code Section 104 and Regulation

Section 104(a)(3) provides an exclusion from gross income for:

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 (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).

(Emphasis added.)

Treasury Regulation § 1.104-1(d) provides as follows:

(d) ACCIDENT OR HEALTH INSURANCE. Section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). Similar treatment is also accorded to amounts received under accident or health plans and amounts received from sickness or disability funds. See section 105(e) and § 1.105-5. If, therefore, 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). See, however, section 213 and the regulations thereunder as to the inclusion in gross income of amounts attributable to deductions allowed under section 213 for any prior taxable year. Section 104(a)(3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. 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 (on either a group or individual basis), the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. If the employer and his employees contribute to a fund or purchase insurance which pays accident or health benefits to employees, section 104(a)(3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the employer's contributions. See § 1.105-1 for rules relating to the determination of the amount attributable to employer contributions. Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee's gross income under section 104(a)(3), they may be excludable therefrom under section 105. See §§ 1.105-1 through 1.105-5, inclusive. For treatment of accident or health benefits paid to or on behalf of a self-employed individual by a trust described in section 401(a) which is exempt under section 501(a) or under a plan described in section 403(a), see paragraph (g) of § 1.72-15. [Added April 13, 1964, by T.D. 6722.]

(Emphasis added.)

4. Code Section 105 and Regulation

Code Section 105 provides as follows:

(a) AMOUNTS ATTRIBUTABLE TO EMPLOYER CONTRIBUTIONS. Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income 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.

(b) AMOUNTS EXPENDED FOR MEDICAL CARE. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d)) of the taxpayer, his spouse, and his dependents (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof). Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this subsection.

(e) ACCIDENT AND HEALTH PLANS. For purposes of this section and section 104 —
(1) amounts received under an accident or health plan for employees, and

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(2) amounts received from a sickness and disability fund for employees maintained under the law of a State or the District of Columbia,

shall be treated as amounts received through accident or health insurance.

(Emphasis added.)

Treasury Regulation § 105-5(a) provides as follows:

(a) IN GENERAL. Sections 104(a)(3) and 105(b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105(e) provides that for purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. **An accident or health plan may be either insured or noninsured**, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

(Emphasis added.)

Thus, Sections 104 and 105 use all of the following terms: "accident or health insurance (or through an arrangement having the effect of accident or health insurance)" (§ 104(a)(3)), "accident or health insurance" (§ 1.104-1(d)), "accident or health insurance" (§ 105(a)), "accident or health plan" (§ 105(e)). In all cases, the terms are ultimately defined to include self-insured, fully insured, or partially insured arrangements. The above statutory and regulatory provisions are clear that the definition of accident or health insurance has been interpreted broadly to include both insured and self-insured health plans. In any case, the tax result for the employee (or retiree) is the same with respect to the health coverage. We believe there is no support for deviating from this accepted precedent for health and accident plans with respect to the implementation of Section 845 of the PPA. The above provisions are very long-standing (for example, the § 1.105 Regulations dating to April 13, 1964) and universally used. We think they have a clearly understood and accepted meaning and, therefore, provide the best source of reference.

It is important to keep in mind that the purpose of Section 845 was to permit any retired public safety officer who meets the eligibility requirements under the statute and who has "qualified health insurance premiums" to take advantage of the \$3,000 tax exclusion. Thus, the statutory phrase "accident

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or health insurance plan" is not intended to be a limiting phrase but, rather, to be a broader, more inclusive phrase, covering retirees who continue coverage under an employer's health plan (whether fully insured or self-insured), as well as retirees who have obtained coverage through another source, such as an individual policy where his or her employer did not offer retiree health coverage. While the public safety sector retirees are more likely to have some type of employer-funded retiree health coverage than perhaps other types of retirees, the statutory language certainly reflects an intention to also provide the benefit to those eligible retirees who must obtain coverage on their own.

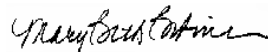
We respectfully request that the Service issue a revised Q&A-23, providing that qualified health insurance premiums may include premiums for coverage under any type of accident or health plan, as defined under Treas. Reg. § 1.104-1(d) or Treas. Reg. § 1.105-5(a), regardless of whether the plan is insured or self-insured. Specifically we believe the answer to Question 23 would be: "The accident or health insurance plan must meet the requirements of Treasury Regulation Section 1.104-1(d) or 1.105-5(a)." This interpretation would be well understood, would be consistent with existing regulations on the treatment of accident and health plans, and would best effectuate Congressional intent to provide this benefit to all eligible retired public safety officers.

Timing is of the essence on this guidance, due to the extensive resources and efforts needed at the employer level and the pension system level to implement this benefit. Additionally, if there is some other rationale for the IRS interpretation under Q&A-23 which we have not addressed, we would welcome the opportunity to discuss that with you.

Thank you for considering these comments. We would welcome the opportunity to discuss with you any of the issues addressed in this letter. We can be reached at the telephone numbers and e-mail addresses listed on the first page of this letter.

Very truly yours,

ICE MILLER LLP



Mary Beth Braitman



Terry A.M. Mumford



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cc: Angelique V. Carrington