



# OVERVIEW AND ANALYSIS SUPPORTING THE FAVORABLE FEDERAL TAX TREATMENT OF PUBLIC SCHOOL EMPLOYEE RETIREE HEALTHCARE CONTRIBUTIONS

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## *For MPERS Reporting Units*

In light of recent statutory changes that have been made to the Michigan Public School Employees Retirement System's (MPERS) retiree healthcare plan ("MPERS Plan"), several important questions have arisen as to the federal tax treatment of certain contributions being made to the MPERS Healthcare Trust ("Healthcare Trust"). In view of the fact that these issues directly impact each of the 680+ Michigan public school districts, community colleges, and universities that participate in MPERS (hereinafter, in the aggregate referred to as "Reporting Units"), along with more than 200,000 current and former employees of the Reporting Units who retire and become eligible for benefits under the MPERS Plan ("Employees") (collectively the Reporting Units and Employees are referred to as "Taxpayers"), the following summary and analysis is provided to inform interested parties of the applicable federal regulations and rulings that govern the tax treatment of contributions to the Healthcare Trust at issue. This overview is not intended – nor should it be construed – as legal advice.<sup>1</sup> Taxpayers are encouraged to seek and obtain their own counsel as to any federal tax liability they might incur, the ultimate determination of which is made by the Internal Revenue Service (IRS).

### ISSUES

Whether the 3% mandatory reduction from the compensation of Employees for which the Reporting Units remit as employer contributions to the Healthcare Trust pursuant to 2012 PA 300 (the "mandatory contributions") should be excluded from gross income and wages for purposes of federal taxation. (Note that this document does not review any tax aspects of 457 Plan contributions made by Employees of the Reporting Units.)

### **IRS Determination Regarding the Federal Tax Treatment of the Retiree Healthcare Contributions**

Although the IRS has not issued a global determination as to the federal tax treatment of the retiree healthcare contributions provided under 2012 PA 300, the IRS has recently – in early 2016 – formally considered and issued rulings against certain protective claims for refunds filed by individual Reporting Units related to contributions at issue. The IRS has indicated, in pertinent part, that the mandatory contributions provided under 2012 PA 300 are considered employee contributions (not employer contributions) to the Healthcare Trust and, thus, they are not excluded from

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<sup>1</sup> The private letter rulings cited in this overview apply only to the taxpayer that received the ruling and cannot be used or cited as precedent, but are exemplary of prior analysis and conclusions of similar facts presented to the IRS.

taxable gross income under Code Section 106 and, as such, also are considered wages under Code Section 3121(a) with respect to FICA taxes.

In contrast, the IRS has indicated – informally – that the 3% mandatory contributions made pursuant to 2010 PA 75 are considered employer contributions excluded from taxable gross income under Code Section 106 and not considered wages under Code Section 3121.<sup>2</sup>

## **BACKGROUND**

Each Reporting Unit is responsible for reporting, deducting, and remitting applicable taxes on their employees' gross income in accordance with federal tax regulations. Since the enactment of the aforementioned statutory changes to the MPERS Plan – which require Reporting Units to reduce the Employees' compensation by three percent and remit such amounts as an employer contribution to the Healthcare Trust – most Reporting Units have treated and reported these mandatory contributions as being excludable from employees' gross income and wages for purposes of federal taxation. On the other hand, a distinct minority of Reporting Units have reported these mandatory contributions as being taxable and assessed applicable taxes accordingly. Of this latter group, several Reporting Units have filed protective claims for refunds with the IRS relative to these amounts.

As of February 2016, the IRS has begun issuing determinations on the aforementioned protective claims – all of which have been adverse to the Taxpayers. While these administrative determinations are not final – as they are subject to appeal – they nevertheless indicate the IRS's view that the mandatory contributions to the Healthcare Trust at issue are taxable income and wages, which would potentially impact all Taxpayers. (Note that in its determinations the IRS has also commented on the taxability of 457 Plan contributions, which are not reviewed in this document.)

## **SUMMARY OF RETIREE HEALTHCARE PLAN STRUCTURE**

The State originally created a system providing retirement benefits for employees of the State's public school and other education-related entities under Michigan Public Act 136 of 1945. This system was re-codified and currently operates under the provisions of Michigan Public Act 300 of 1980, as amended; also known as the "The Public School Employees Retirement Act" or "MPERS Act." MCL 38.1301 *et seq.*

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<sup>2</sup> It must be emphasized, however, that the IRS has not formally decided the federal tax treatment of the 2010 PA 75 contributions; rather, the IRS has indicated that it will hold in abeyance a formal determination pending further review.

The MPERS Act creates cost sharing, State-wide, multiple-employer plans, including a qualified defined benefit pension plan under Code Section 401(a) (“MPERS Pension Plan”) and a retiree Healthcare plan (“MPERS Healthcare Plan”). There are approximately 685 participating State political subdivisions in the overall MPERS system, including K-12 public school districts, public school academies, district libraries, tax-supported community colleges and seven state public universities (“Reporting Units”).

Pursuant to Michigan Public Act 77 of 2010, the Public School Employees Retirement System Healthcare Trust, a Code Section 115 trust (“Healthcare Trust” or “Trust”), was created for the purpose of funding retirement health benefits for MPERS Healthcare Plan participants. It is this Trust that receives the employer contributions from the Reporting Units, including the mandatory contributions which are discussed in this letter ruling request.

The MPERS Healthcare Plan and Healthcare Trust are administered by the Office of Retirement Services within the Michigan Department of Technology, Management & Budget. The Department Director appoints the Office Director, with whom the general oversight of the MPERS Healthcare Plan and Healthcare Trust resides. The State Treasurer serves as the investment officer and custodian for the Healthcare Trust.

### **SUMMARY OF RETIREE HEALTHCARE PLAN CHANGES AT ISSUE**

Under Michigan **Public Act 75 of 2010**, the State of Michigan began requiring a 3% mandatory reduction to Employees’ compensation to be remitted to the Healthcare Trust as an employer contribution.<sup>3</sup> Retiree healthcare contributions provided under 2010 PA 75 were assessed and remitted from July 1, 2010 until September 3, 2012.

Under Michigan **Public Act 300 of 2012**, which became effective on September 4, 2012 and remains in effect, the Reporting Units continued the 3% mandatory reduction in Employees’ compensation and remittance of them as an employer contribution to the Healthcare Trust. However, under Act 300, Employees in late 2012 were given a brief, one-time irrevocable election window to opt out of the future right to receive any health benefits (including health insurance premium subsidies) under the MPERS Healthcare Plan, with the result that they would no longer be subject to a 3% mandatory reduction in their compensation. Employees who did not opt-out under this one-time irrevocable

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<sup>3</sup> It is noted that, for Employees who made less than \$18,000 in 2009-10, and new Employees who were expected to make \$18,000 in the 2010-11 school year, were required to contribute 1.5% in 2010-11 and 3% thereafter.

election window continue to experience a 3% mandatory reduction in their compensation, which is remitted as an employer contribution to the Healthcare Trust, and retain the future right to receive premium subsidies under the MPSERS Plan. Once the one-time irrevocable election period closed in early 2013, Employees became locked in and have not have (and will not in the future have) any individual or discretionary rights to modify or revoke their election, or to make individual elections of any kind with respect to the MPSERS Healthcare Plan. Further, there is no election as to the level of mandatory contributions to the Healthcare Trust (on the part of the Reporting Units or Employee). These amounts are calculated and determined by the State statute and are mandatory with respect to all eligible Employees, who retain only the future right to receive health benefits under the MPSERS Healthcare Plan.

Only Reporting Unit employer contributions, which include the mandatory contributions, are made to the Healthcare Trust. Mandatory contributions to the Healthcare Trust are made only during an Employee's active employment. Upon retirement, if an Employee satisfies the eligibility conditions for health benefits (including health insurance premium subsidies) under the MPSERS Healthcare Plan, the Healthcare Trust is used to pay for those benefits. The assets of the Healthcare Trust can be used solely for the payment of health benefits that constitute expenses for "medical care" (as defined under Code Section 213(d)) incurred after an eligible Employee's retirement, and for administrative expenses of the MPSERS Healthcare Plan or Healthcare Trust; the assets cannot be used or diverted for any other purpose. If an Employee is not eligible for health benefits under the MPSERS Healthcare Plan (e.g. he/she does not meet the eligibility conditions under the MPSERS Healthcare Plan upon retirement or dies before becoming eligible), the Healthcare Trust will not pay any cash or other non-health benefits to such Employee (or his/her beneficiaries) in lieu of health benefits.<sup>4</sup>

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<sup>4</sup> Public Act 300 of 2012 provides that if an Employee is subject to the 3% mandatory contributions to the Healthcare Trust, but subsequently does not become eligible for health benefits in accordance with the terms of the MPSERS Healthcare Plan, then such Employee (or the beneficiary of a deceased Employee) will receive a separate retirement allowance in an amount determined under the terms and paid from the separate assets of the MPSERS Pension Plan. However, no individual election or discretion on the part of an Employee or his/her beneficiary is permitted as to whether to receive the health benefits under the MPSERS Healthcare Plan or the separate retirement allowance under the MPSERS Pension Plan. In other words, the separate retirement allowance from the MPSERS Pension Plan is payable only when the Employee (or his/her beneficiary) has been determined pursuant to the applicable statutory provisions to not be eligible to receive any health benefits under the MPSERS Healthcare Plan. If the Employee is not

Employer contributions from the Reporting Units, including the mandatory contributions, are deposited in the Healthcare Trust and invested among the investments selected by the State Treasurer as the sole investment fiduciary of the Healthcare Trust; Employees do not in any way direct the investment of Trust assets). The Healthcare Trust's assets are derived solely from these employer contributions, including the mandatory contributions, as well as investment earnings thereon. The Healthcare Trust Agreement expressly provides that (1) the assets of the Healthcare Trust shall be held for the exclusive purposes of providing health benefits to participants (and their eligible spouses and dependents) of the MPSERS Healthcare Plan and for defraying the reasonable expenses of administering the MPSERS Healthcare Plan, (2) no portion of the corpus or income of the Healthcare Trust will revert to the State or any Reporting Units prior to the dissolution of the Trust, and (3) no private interests will participate in or benefit from the operation of the Healthcare Trust other than as bona fide providers of goods or services. After satisfaction of all liabilities of the MPSERS Healthcare Plan, any remaining assets of the Healthcare Trust may be distributed, but only via reversion to the State or a political subdivision of the State and to no other entity.

In each case, the mandatory contributions are derived from a 3% reduction in the Employee's compensation, for which each Reporting Unit remits a comparable amount as an employer contribution to the Healthcare Trust. After the time that the above-noted window period closed for the one-time irrevocable election, no Employee of any Reporting Unit has had (and they never in the future will have) a choice as to whether or not to make the mandatory contributions, nor do Employees have any control over the nature or amount of such contributions. These contributions held by the Healthcare Trust are then subject to the restrictions, protections and other provisions as set forth in the Healthcare Trust Agreement. See Attachment 1.

## **TAX PRINCIPLES REGARDING RETIREE HEALTHCARE CONTRIBUTIONS**

### **26 USC § 61 - Gross Income Defined.**

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

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eligible for health benefits under the MPSRS Healthcare Plan, the retirement allowance will automatically become payable pursuant to the terms of the MPSERS Pension Plan, via payment from a separate Code Section 501(a) retirement trust established by the State. No assets of the Healthcare Trust may be used to pay for that separate retirement allowance or otherwise be transferred to the trust for the MPSERS Pension Plan.

considered to have been provided as compensation to the person performing such services.

### **26 USC §§ 105, 106, 115 – Items Specifically Excluded from Gross Income.**

Section 105(a) provides that, except as otherwise provided in § 105, 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.

Section 105(e) states that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of § 105. Section 1.105-5(a) of the regulations states that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

Section 106 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.

Section 115 provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

### **26 U.S. Code § 451 – General Rule for Taxable Year of Inclusion; 26 CFR 1.451-2 – Constructive Receipt of Income.**

Income, although not actually in the employee's possession, is constructively received by the employee in the taxable year during which it is credited to the employee's account, set apart for the employee, or otherwise made available so that the employee may draw upon it at any time. However, income is not constructively received if the employee's receipt of it is subject to substantial limitations or restrictions.

### **26 U.S. Code §§ 3101, 3111, 3121, 3401 – Rules for Exclusion of FICA and FUTA taxes.**

Section 3101 imposes taxes under the Federal Insurance Contributions Act (FICA) "on the income of every individual" in an amount equal to a percentage "of the wages received by him with respect to employment." Code Section 3111 provides that the employer portion of FICA tax is imposed directly upon the employer as "an excise tax,

with respect to having individuals in his employ.” Similarly, Code Section 3301 provides that FUTA tax is imposed on every employer as an excise tax with respect to individuals in his employ equal to a percentage of wages paid by the employer with respect to employment.

Code Section 3121(a) provides for FICA purposes and Code Section 3306(b) provides for FUTA purposes, with certain exceptions, that the term “wages” means “all remuneration for employment.” However, sections 3121(a)(2) and 3306(b)(2) provide that the term “wages” does not include any payment made to or on behalf of an employee, or any of his dependents, for medical or hospitalization expenses. Code Section 3401(a) provides that for purposes of federal income tax withholding, “wages” means all remuneration for services performed by an employee for his employer, including the cash value of any benefits. However, Rev. Rul. 56-632, 1956-2 C.B. 101, holds that when premiums paid by an employer under policies providing hospital and surgical services are excludable from employees’ gross income under Code Section 106, the amounts paid by the employer are not subject to federal income tax withholding.

### **ANALOGOUS REVENUE RULINGS<sup>5</sup> AND PRIVATE LETTER RULINGS<sup>6</sup>**

In **Rev. Rul. 77-261, 1977-2 C.B. 45**, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under Code Section 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state’s participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

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<sup>5</sup> Note that Revenue Rulings (Rev. Rul.) are public administrative rulings by the IRS in the United States Department of the Treasury of the United States federal government that apply the law to particular factual situations. A Revenue Ruling can be relied upon as precedent by all taxpayers.

<sup>6</sup> Note that the Private Letter Rulings (PLR) referred to herein cannot be used or cited as precedent, but are included to exemplify prior analysis and conclusions of similar facts presented to the IRS.

In **Rev. Rul. 90-74, 1990-2 C.B. 34**, the IRS determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under Code Section 115. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

**Rev. Rul. 75-539, 1975-2 C.B. 45.** This ruling examines two scenarios involving the federal tax treatment accorded to the provision of an employee's accumulated unused sick leave balances. In the first scenario, a labor contract (Contract A) provides that, upon retirement, an employee will receive a portion of accumulated unused sick leave credits as a lump sum cash payment or, at the election of the employee, the payment may be applied instead toward the employee's cost of participating in the employer's health plan. In the other scenario, the labor contract (Contract B) provides that the value of the employee's accumulated unused sick leave credits will be applied toward the employee's cost of participating in the retiree healthcare plan (until the funds are exhausted), with no cash option and any unused funds reverting to the employer.

This ruling holds that, under Contract A, the value of unused accumulated sick leave credits that is to be applied to the employee's cost of participating in the retiree healthcare plan is "constructively received" by the employee under 26 USC § 451, and therefore is includible in the retired employee's gross income. However, under Contract B, the value of the unused accumulated sick leave credits, which are not otherwise payable to the employee as cash, is not constructively received by the retired employee; rather, it is a contribution by the employer to the employer's health plan that is excludable from the retired employee's gross income under 26 USC § 106.

In a series of Private Letter Rulings, the IRS has held that contributions (including mandatory employee contributions) made to a healthcare trust, and benefits payable therefrom exclusively for medical care, are excludable from employees' and retirees' gross income and wages for federal taxation purposes.

In **PLR 200120024**, a governmental employer offered its employees a one-time irrevocable choice between two benefit packages (i) the existing retirement and welfare benefit package with no increase in compensation or (ii) a new package with a lower level of welfare and retirement benefits, but with an additional eight percent (8%) in current compensation. The IRS ruled that this irrevocable election was not a cash or deferred arrangement ("CODA") under Code Section 401(k). The reason for this conclusion was that an employee who chose to make the switch to the package "must surrender his right to participate in the more generous retirement plan and will receive fewer welfare benefits." According to the IRS, this constituted a "substantial limitation on the right to receive higher

compensation.” As a result, the employees who chose to remain with the existing program did not have constructive receipt of the forgone 8% cash compensation under Code Section 451.

**PLR 200914018** similarly involved a one-time irrevocable election to waive retirement health insurance in exchange for a higher rate of pay. Under these facts, the employer required each employee to sign an irrevocable waiver of the retirement health insurance benefit by a fixed date in return for an increased rate of pay. The employer required future eligible employees to similarly execute the one-time irrevocable waiver within 15 days of their contracted day of employment to elect the increased pay rate. Employees who did not exercise the one-time irrevocable election to waive the right to the retirement health insurance benefits by the fixed date or within 15 days of their first contracted date of employment would not be allowed to waive retirement health insurance benefit and, therefore, would not receive the increased rate of pay at any later date. The IRS held that under Code Section 451, an employee would not be in constructive receipt of income due solely to the availability of the one-time irrevocable election to waive retiree health benefits in return for an increase in the rate of pay for future services provided to the employer.

In **PLR 200727002**, a municipal employer established and made employer contributions (including mandatory employee contributions) to a fund used solely to pay for post-retirement health benefits for employer’s eligible retirees and their spouses and dependents as defined in Code Section 152. No fund assets, including income, could revert to the employer or be distributed to anyone other than covered retirees for post-retirement medical benefits for themselves or their spouse and dependents. The employee contributions were mandatory for all employees who would derive benefits under the employer’s retiree health plan without any election by the employee. The IRS held that the fund, including income thereon, that provided health benefits to retired employees of the municipal employer constituted the performance of an essential government function and, therefore, the fund’s income was excludable from gross income under Code Section 115(1). The IRS also held that amounts paid to the fund (through employer and mandatory employee contributions) and amounts paid from the fund which were used solely to pay for health insurance premiums of retired employees and their spouses and dependents as defined in Code Section 152 (determined without regard to Code Sections 152(b)(1), (b)(2), and (d)(1)(B)) were excludable from gross income under Code Sections 105(b) and 106 and did not constitute “wages” under Code Section 3121(a)(2).

**PLR 200938009** similarly involved a state’s Code Section 115 retiree health trust to which mandatory employee contributions were made. The IRS held that the

mandatory employee contributions and income trust assets were excludable from gross income under Code Sections 106 and 115 and were not wages for purposes of FICA, FUTA and income tax withholding under Code Sections 3101, 3111, 3301 and 3402.

In **PLR 201345020**, a City entered into collective bargaining agreements and adopted Resolutions and ordinances that required employee contributions through mandatory reductions in salary to be made to the City's healthcare trust. Once the agreements were entered and the Resolutions and ordinance adopted, no employee could elect to receive salary or benefits in lieu of making the mandatory employee contributions. The IRS held that the mandatory employee contributions made to the City's healthcare trust are treated as employer contributions excludable from the City's employees' gross income under Code Section 106 and are not wages and thus not subject to FICA taxes under Code Section 3121(a), FUTA taxes under Code Section 3306(b) or income tax withholding under Code Section 3401(a).

Similarly, **PLR 200846011** and **PLR 201003007** involved collective bargaining agreements where the unions, on behalf of its union-employee members, negotiated with the employer to have its members covered under the employer's retiree health program and thereby agreed that its union-employee members would make mandatory employee contributions to the employer's retiree healthcare trust. After the union, on behalf of its union-employee members, made the election to participate in the retiree health program, union employees had no individual election with respect to such participation, including no right to receive cash in lieu of participation under the Plan. The IRS held that the mandatory employee contributions that are used exclusively to pay for accident or health coverage for retired employees, their spouses and dependents (as defined under Code Section 152) were excludable from gross income under Code Section 106.

**PLR 200802003** involved a municipal employer's post-retirement health plan to which only employer contributions could be made or accepted. The employer contributions included mandatory employee contributions and mandatory contributions of accumulated leave which were not actually or constructively received by the participant. The employees had no individual election under the plan, including no election as to whether or not to participate (other than for union employees unless their collective bargaining agreements negotiated participation in the plan) and no election as to the level of mandatory contributions. Employer contributions to the plan were deposited into a Code Section 115 trust and invested among investments selected by the municipal employer. Trust assets, including income thereon, were held for the exclusive

purposes of providing benefits to participants (and their eligible spouses and dependents) and defraying the reasonable expenses of administering the plan and trust. The trust provisions provided that no portion of the trust corpus or income could revert to the employer and no private interests participate in or benefit from the operation of the trust other than as providers of goods or services. The plan reimbursed retired employees and their spouses and eligible dependents (defined under Code Section 152) solely for health insurance or medical care expenses (as defined under Code Section 213(d)) incurred after retirement. The Service determined that the income of the Trust was derived from the exercise of an essential government function and accrued to a government entity and, thus, was excludable from gross income under 26 USC § 115. The IRS likewise determined that the mandatory employee contributions and mandatory contributions of accumulated leave made to the Trust on behalf of employees for the purpose of providing post-employment health coverage to the employees, their spouses and dependents was excludable from gross income under 26 USC § 106. (*See also* **PLR 201034012** and **201245010**).

## **ANALYSIS**

### **Introduction**

As noted above, in the initial determinations received by certain Reporting Units from the IRS with respect to their protective refund claims, the IRS has taken the position that the mandatory contributions provided under 2012 PA 300 are akin to “voluntary salary reduction contributions,” and thus are considered taxable gross income and wages. The IRS heavily relies on Revenue Ruling 75-539 in reaching its conclusion. For the reasons set forth below, however, it is submitted that the mandatory contributions made to the Healthcare Trust pursuant to Michigan Public Acts 75 of 2010 and 300 of 2012 should be treated as employer contributions that are excludable from gross income under Code Section 106 and, as such, should not be treated as “wages” subject to FICA taxes under Code Section 3121(a), FUTA taxes under Code Section 3306(b) or income tax withholdings under Code Section 3401(a).

What follows is an overview of the arguments that have been asserted by MPSERS in a Private Letter Ruling request in support of a favorable global ruling as to the federal tax treatment to be accorded to the retiree healthcare contributions at issue.

### **Summary of Arguments in Support of the Favorable Federal Tax Treatment of Healthcare Contributions under 2010 PA 75 and 2012 PA 300**

#### ***I. Analysis Regarding Exclusion of Mandatory Contributions from Gross Income and Wages for Federal Tax Purposes***

Under both Michigan Public Act 75 of 2010 and 300 of 2012, Reporting Unit Employees (and their beneficiaries), at the time of retirement, have no right to receive cash from the Healthcare Trust in lieu of health benefits provided under the MPSERS Healthcare Plan. This was the case under Michigan Public Act 75 of 2010 and remains true even after taking into account the brief, one-time irrevocable election provided under Michigan Public Act 300 of 2012.

Beginning with Michigan Public Act 75 of 2010, and continuing under Act 300 of 2012, Employees have no right, at the time of retirement, to receive cash from the Healthcare Trust in lieu of benefits provided under the MPSERS Healthcare Plan. This remains true even after taking into account the brief, one-time irrevocable election implemented under Michigan Public Act 300 of 2012.

The one-time irrevocable election provided under Michigan Public Act 300 of 2012 simply gave Employees the ability to irrevocably opt-out, during a fixed window time period back in 2012, of any future rights to receive health benefits under the MPSERS Healthcare Plan. Employees who did not opt-out under that one-time irrevocable election window automatically continued to be subject to an irrevocable 3% mandatory reduction in their compensation, and the resulting compensation savings to the Reporting Units continue pursuant to State statute to be remitted as employer contributions to the Healthcare Trust. Those Employees who did not opt-out and who thereby retained the future right to receive health benefits under the MPSERS Healthcare Plan do not have any individual or discretionary rights to modify or revoke that election in the future nor do they have any individual elections within the Healthcare Trust itself, including having no right to elect the level of mandatory contributions. All mandatory contributions are fixed and determined pursuant to State statute and are mandatory with respect to all Employees who participate in and retain the future right to receive health benefits under the MPSERS Healthcare Plan.

With regard to Revenue Ruling 75-539, as cited by the IRS in the aforementioned protective claim determinations, unlike Contract A under that Ruling, there is no subsequent election by an employee with regard to any amount that will be taken in cash under the current MPSERS Plan. Contract A under the Ruling involved a plan that provided an employee with a choice at retirement between a cash payment of unused sick leave and application of that unused sick leave to the cost of the employee's post-employment health insurance until exhausted. With the MPSERS Plan, there is no subsequent election that can be made by an employee who continues to receive a 3% reduction in his/her compensation which is remitted as an employer contribution to the Healthcare Trust. That is, under Michigan Public Act 75 of 2010 *and* also under Michigan Public Act 300 of 2012 once an Employee made his or her one-time irrevocable election to receive premium subsidies under the MPSERS Plan (and, thus, a

3% reduction in his or her compensation that is remitted to the Healthcare Trust) during the window period, such Employee thereafter does not have any future right to elect to receive a cash payment from the Healthcare Trust in lieu of receiving the premium subsidies under the MPSERS Plan.

By contrast, Contract B (also from Revenue Ruling 75-539) involved all of an employee's accumulated unused sick leave being placed in an account to pay for post-employment health insurance until the funds were exhausted, with no cash option to the employee and any unused funds reverting to the employer. With the MPSERS Plan, all amounts that are mandated to be contributed to the Healthcare Trust will similarly be used to pay post-employment health benefits until exhausted, with neither the ability of the Employee (or his/her beneficiaries) to elect to receive cash from the Healthcare Trust in lieu of such premium subsidies under the MPSERS Plan nor a reversion to the Reporting Units of such assets. Under that similar scenario, Revenue Ruling 75-539 stated with respect to Contract B that this did not create a constructive receipt problem and the value of the retiree benefit is excludable from income under Code Section 106.

Furthermore, the one-time irrevocable election under Michigan Public Act 300 of 2012 is similar to the one-time irrevocable elections described in PLRs 200120024 and 200914018 and should not be considered to constitute a cash or deferred arrangement. Specifically, Employees who made the one-time irrevocable election forever surrendered their right to receive health benefits under the MPSERS Healthcare Plan. This type of one-time irrevocable election clearly constituted a substantial limitation on such an Employee's right to receive higher compensation — i.e. the employee would be making the irrevocable election to surrender his/her future right to receive health benefits under the MPSERS Healthcare Plan. As a result, those Employees who chose to remain eligible for health benefits under the MPSERS Healthcare Plan upon retirement should not be considered to have constructive receipt of the forgone 3% mandatory reduction in his or her compensation under Code Section 451. Similar to the arrangements described in PLRs 201345020, 200846011, 201003007 (which involved mandatory employee contributions made to a trust after a collectively bargained group of employees negotiated and opted to be covered under a retiree Healthcare plan), Employees who did not opt-out by the close of the fixed window period under Michigan Public Act 300 of 2012, have no subsequent right to receive salary or benefits in lieu of making the mandatory contributions to the Healthcare Trust, and, thus should not be held to be in constructive receipt of such 3% mandatory reduction in their compensation.

The concept of "significant detriment" also can be applied to the one-time irrevocable election Employees made pursuant to Michigan Public Act 300 of 2012. This tax doctrine is applied in several employee benefits contexts, the essence of which is that an

individual taxpayer does not have control, and thus does not have taxable income, when the options presented involve any significant detriment. For example, Treas. Reg. Section 1.411(a)-11(c)(2)(i) cites this doctrine as a basis for concluding that consent cannot be given when a significant detriment is imposed on one who does not give consent; under those circumstances one's "consent" cannot be considered voluntary.

In this vein, it is important to examine the context of the brief, one-time irrevocable election which Employees made back in 2012 under Michigan Public Act 300 of 2012. Those Employees had only one choice – to opt in or out of the health benefits under the MPSERS Healthcare Plan in its entirety. In other words, any election made during this one-time irrevocable election window essentially provided an Option A to retain the right to receive health benefits under the MPSERS Healthcare Plan, or an Option B of no future benefits under the MPSERS Healthcare Plan. Any choice made at that time, therefore, involved a corresponding limitation, restriction, or detriment – a 3% reduction in compensation that is remitted as an employer contribution to the Healthcare Trust along with health benefits under the MPSERS Healthcare Plan, versus no health benefits at all. Moreover, this factor has further significance in view of the fact that this 2012 election was an irrevocable choice as to whether to continue participating in the program – a "choice" that had very long-term and lasting consequences.

This fact is bolstered in several further respects. One is that under the one-time irrevocable election window, an Employee who failed to make any election at all automatically continued to be eligible for health benefits under MPSERS Healthcare Plan and, thereby, subject to the 3% reduction in compensation that is remitted as an employer contribution to the Healthcare Trust. The second fact demonstrating the significant detriment attached to an Employee's healthcare "choice," is that approximately 90% of all Employees have continued to be eligible under the MPSERS Healthcare Plan (subject to the corresponding 3% reduction in compensation), by either having affirmatively elected to do so via the 2012 window, or by making no election at all at that time. A third point is that for many of the Employees, choosing to opt-out of future MPSERS Healthcare Plan benefits meant that they would effectively be leaving behind rights to valuable benefits that had already accrued for them, since MPSERS Healthcare Plan benefits were (and still are) in major part based on vesting related to Reporting Unit service longevity – so a very difficult choice indeed. All of this indicates that opting out under this brief, one-time election window involved a serious decision to permanently end any health benefits provided by the MPSERS Healthcare Plan for that Employee. Under these facts, the significant detriment doctrine can be applied in support of a conclusion that an Employee making his or her irrevocable election with respect to the MPSERS Healthcare Plan should neither be deemed to have

made a cash or deferred election nor to be in constructive receipt of the 3% mandatory reduction in compensation.

In summary, all amounts that are statutorily mandated to be contributed to the Healthcare Trust under Michigan Public Acts 75 of 2010 and 300 of 2012 are solely used to pay post-employment health benefits (or administrative costs of the MPSERS Healthcare Plan or Healthcare Trust), with neither the ability of the Employee (or his/her beneficiaries) to make a subsequent election at retirement to receive cash from the Healthcare Trust in lieu of such health benefits under the MPSERS Healthcare Plan, nor the possibility for a reversion of such contributions to the State or its Reporting Units. In other words, an Employee who irrevocably opted out of the MPSERS Healthcare Plan back in 2012 will never have the right to opt back into such Plan. Conversely, Employees who did not make the one-time opt-out election during the fixed window period back in 2012 have remained eligible to receive health benefits under the MPSERS Healthcare Plan upon retirement and continue to be subject to the 3% mandatory reduction in their compensation, which amount is remitted pursuant to State statute as a Reporting Unit employer contribution to the Healthcare Trust. Moreover, Employees who remain eligible under the MPSERS Healthcare Plan do not, pursuant to the MPSERS Act, have any subsequent right to elect to receive a cash payment from the Healthcare Trust in lieu of receiving the health benefits under the MPSERS Healthcare Plan. In other words, for the MPSERS Healthcare Plan, since the time of the initial one-time irrevocable election in 2012, there has been and is no individual employee election option within respect to the MPSERS Healthcare Plan, including there being no right to subsequently discontinue mandatory contributions while employed by a Reporting Unit, no election at all as to the level of contributions, and no right to elect cash in lieu of the health benefits under the MPSERS Healthcare Plan.

Once the brief, one-time irrevocable election period closed under Michigan Public Act 300 of 2012, the structure of these mandatory contributions to the Healthcare Trust became akin to the mandatory contributions made under "Contract B" of Rev. Rul. 75-539 as well as those reviewed in PLRs 200727002, 200802003, 200846011, 200938009, 201003007, 201034012, 201245010 and 201345020. Under all of these rulings, the Service treated the mandatory contributions as employer contributions excludable from gross income under Code Section 106 and as not being "wages" subject to federal employment taxes. By contrast, here, the mandatory contributions to the Healthcare Trust are clearly distinguishable from the "Contract A" arrangement described in Revenue Ruling 75-539 because Reporting Unit Employees who continued as participants in the MPSERS Healthcare Plan (and did not make the one-time irrevocable opt-out election under Michigan Public Act 300 of 2012), have retained no subsequent

rights or discretion to elect a cash payment from the Healthcare Trust in lieu of receiving the health benefits under the MPSERS Healthcare Plan.

## ***II. Analysis Regarding Exclusion of Health Benefits (Including Health Insurance Premium Subsidies) Payable to or on behalf of Retirants from Gross Income and Wages for Federal Tax Purposes***

The terms of the MPSERS Healthcare Plan and Healthcare Trust, which are embodied in State statutory law under MPSERS Act (as amended), specifically provide that assets of the Healthcare Trust can be used solely for the payment of expenses for “medical care” (as defined under Code Section 213(d)) incurred after an eligible Employee’s retirement and to defray administrative expenses of the MPSERS Healthcare Plan and Healthcare Trust; the assets cannot be used or diverted for any other purpose.

If an Employee satisfies the eligibility conditions for health benefits under the MPSERS Healthcare Plan upon retirement, the Healthcare Trust will be used to pay for such Employee’s health benefits and to generally fund any other health benefits payable under the MPSERS Healthcare Plan. By contrast, if an Employee is not eligible for health benefits under the MPSERS Healthcare Plan (e.g. he/she does not meet the eligibility conditions under the MPSERS Healthcare Plan upon retirement or dies before becoming eligible), the Healthcare Trust will not pay any cash or other non-health benefits to such Employee (or his/her beneficiaries) in lieu of health benefits.

As a result, any health benefits paid to or on behalf of eligible retirants and their eligible spouses and dependents from the Healthcare Trust and under the MPSERS Healthcare Plan should be treated as being excludable from retirants’ gross income under Code Section 105 and also should not be treated as “wages” subject to FICA or FUTA taxes or income tax withholding under Code Sections 3121(a), 3306(b) and 3401(a), respectively.

## ***III. Analysis Regarding Exclusion of Income Earned Under the Healthcare Trust from Taxable Income for Federal Tax Purposes***

The Healthcare Trust provides health benefits to retired Employees of Reporting Units, their spouses and eligible dependents. The Reporting Units are political subdivisions of the State of Michigan. Accordingly, the Healthcare Trust performs an essential governmental function for the State within the meaning of Code Section 115(1) by providing health benefits to former Employees of the Reporting Units. No private interests participate in or benefit from the operation of Healthcare Trust other than as bona fide providers of goods and services, and any such benefit to insurance companies or Healthcare providers should be considered incidental to the overall public benefit and essential governmental function served by the Healthcare Trust. Only upon dissolution of the Healthcare Trust and after all liabilities of the MPSERS Healthcare

Plan have been satisfied, may the assets of the Healthcare Trust be distributed, and then solely to the State of Michigan or a political subdivision thereof and not to any other entity. The Statement of Facts section above sets forth additional features of the Healthcare Trust, including investment provisions, all of which fully support a conclusion that the income of the Healthcare Trust derives from the exercise of an essential government function and will accrue to the State of Michigan or a political subdivision thereof. Consequently, the income of the Healthcare Trust should be treated as being excludable from gross income pursuant to Code Section 115(1).

### **Conclusion**

Based on the foregoing, MPERS has submitted a PLR request to the IRS asking that the following rulings be made:

- (1) Contributions (including mandatory contributions) that are made to the Health Care Trust pursuant to State law for Employees participating in the MPERS Health Care Plan are excludable from Employees' gross income under Code Section 106.
- (2) Contributions (including mandatory contributions) that are made to the Health Care Trust pursuant to State law eligible for Employees participating in the MPERS Health Care Plan are not "wages" subject to FICA taxes under Code Section 3121(a), FUTA taxes under Code Section 3306(b) or income tax withholding under Code Section 3401(a).
- (3) Health benefits (including health insurance premium subsidies) paid from the Health Care Trust pursuant to the MPERS Health Care Plan to or on behalf of eligible retirees and their eligible spouses and dependents are excludable from retirees' gross income under Code Section 105 and are not "wages" subject to FICA or FUTA taxes or income tax withholding under Code Sections 3121(a), 3306(b) and 3401(a), respectively.
- (4) The income of the Health Care Trust is derived from the exercise of an essential government function and will accrue to the State of Michigan or a political subdivision thereof, and thus is excludable from gross income pursuant to Code Section 115(1).

**Although the aforementioned PLR request may ultimately affect the status of protective claims involving the same issues, Taxpayers and interested parties are reminded that the responsibility for preserving and pursuing individual claims remains their own. This may include the timely appeal of any denial of a protective**

Overview and Analysis

Page 18

April 6, 2016

**claim issued to a Taxpayer, utilizing any number of appeal methods as outlined by the IRS in the denial letters.**

## **ATTACHMENT 1: MEMBER EMPLOYEE CONTRIBUTIONS MANDATED UNDER MICHIGAN LAW**

These mandatory contributions are set forth in Michigan law, as follows:

Section 43e of the MPERS Act provides for a mandatory contribution for each employee that participates in the retiree healthcare plan. There was provided a one-time, limited window for an employee to make an irrevocable election to discontinue participation in the retiree health plan in its entirety. Every employee who participates in the retiree healthcare plan, however, is subject to the mandatory contribution. There is no annual option or election (or an option or election at any other time) as to whether to continue participation in the plan. And as a participant in the plan, there is no option or election with regard to whether the employee will pay the employee contribution, nor any option or election to pay an amount that is greater or smaller than the mandatory contribution that is mandated by state law. The portion of the MPERS Act that requires the employee contribution and treats it as an employer contribution, is as follows:

Except as otherwise provided in this section or section 91a, each Employee who first became an Employee before September 4, 2012 shall contribute 3% of the Employee's compensation to the appropriate funding account established under the public employee retirement Healthcare funding act, 2010 PA 77, MCL 38.2731 to 38.2747. The Employee contributions under this section shall be deducted by the employer and remitted as employer contributions in a manner that the retirement system shall determine. As used in this section, "funding account" means the appropriate irrevocable trust created in the public employee retirement Healthcare funding act, 2010 PA 77, MCL 38.2731 to 38.2747, for the deposit of funds and the payment of retirement Healthcare benefits. [MCL 38.1343e (emphasis added)].

Section 91a of the MPERS Act provided a one-time election for employees to opt out of participation in the retiree healthcare plan provided by MPERS. That portion of the Act provides as follows:

(5) Except as otherwise provided in this section, beginning September 4, 2012 and ending at 5 p.m. eastern standard time on January 9, 2013, the retirement system shall permit each qualified Employee to make an election to opt out of health insurance coverage premiums that would have been paid by the retirement system under section 91 and opt into the Tier 2 account provisions of this section effective on the transition date. A qualified Employee who makes the election

under this subsection shall cease accruing years of service credit for purposes of calculating a portion of the health insurance coverage premiums that would have been paid by the retirement system under section 91 as if that section continued to apply. [MCL 38.1391a(5)]

Section 91 of the MPERS Act provides for retiree healthcare, but provides that this plan is not available to certain employees. For example, it is not available to any newly hired employee after September 4, 2012 or any employee who opts out of the healthcare plan during the one-time election window. That portion of the Act provides as follows:

(15) This section does not apply to a retirant or a health insurance dependent of that retirant under either of the following circumstances:

(a) The individual first became an Employee or qualified participant on or after September 4, 2012.

(b) The Employee made the election to opt out of health insurance coverage or receives a separate retirement allowance under section 91a. [MCL 38.1391(15)].