[4830-01-p] Published July 17, 2003

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

TD 9079

RIN 1545-BA47

10 or More Employer Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations that provide rules regarding the requirements for a welfare benefit fund that is part of a 10 or more employer plan. The regulations affect certain employers that provide welfare benefits to employees through a plan to which more than one employer contributes.

DATES: Effective Date: These regulations are effective July 17, 2003.

Applicability Date: For dates of applicability, see §1.419A(f)(6)-1(g).

FOR FURTHER INFORMATION CONTACT: Betty J. Clary, (202) 622-6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1795. Responses to these collections of information are required to obtain a benefit (to be treated as a 10 or more employer plan excepted from the deduction limits for employer contributions to a welfare benefit fund).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent and/or recordkeeper varies, depending on individual circumstances, with an estimated average of 25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations under section 419A of the Internal Revenue Code (Code). Sections 419 and 419A, which were added to the Code by section 511 of the Deficit Reduction Act of 1984 (Public Law 98-369, 98 Stat. 494) set forth special rules limiting the deduction of employer contributions to a welfare benefit fund. Pursuant to section 419A(f)(6), the rules of sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a plan to which more than one employer contributes and to which no employer normally contributes more than 10 percent of the contributions of all employers under the plan, but only if the plan does not maintain experience-rating arrangements with respect to individual employers.

Section 419A(i) of the Code provides that the Secretary shall prescribe regulations as may be appropriate to carry out the purposes of sections 419 and 419A. Section 419A(i) further provides that the regulations may provide that the plan administrator of any welfare benefit fund to which more than one employer contributes shall submit such information to the employers contributing to the fund as may be necessary to enable the employers to comply with the provisions of section 419A.

The legislative history of sections 419 and 419A of the Code explains that the principal purpose of the deduction limits for contributions to welfare benefit funds "is to prevent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984), 1984-3 C.B. (Vol. 2) 1, 409.

The legislative history of section 419A(f)(6) of the Code explains that the reason the deduction limits of sections 419 and 419A do not generally apply to a fund that is part of a 10 or more employer plan is that "the relationship of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1159 (1984), 1984-3 C.B. (Vol. 2) 1, 413. Thus, the premise underlying the exception is that no special limitation on deductions is necessary in situations where a payment by an employer in excess of the minimum necessary to currently provide for the benefits under the plan is effectively lost to that employer, because the economics of the plan will discourage excessive contributions.

The 10 or more employer plan exception to the deduction limitation does not apply, however, where the plan maintains experience-rating arrangements with respect to individual employers. The reason for excluding these plans from the exception is that an experience-rating arrangement with respect to an individual employer changes the economics of the plan and allows an employer to contribute an amount in excess of the minimum amount necessary to provide for the current benefits with the confidence that the excess will inure to the benefit of that employer as the excess is used to provide benefits to its employees. The legislative history notes that making the exception to the deduction limits unavailable to plans that determine contributions on the basis of experience rating is consistent with the general rules relating to the definition of fund because "the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1159 (1984), 1984-3 C.B. (Vol. 2) 1, 413.

In Notice 95-34 (1995-1 C.B. 309), the IRS identified certain types of arrangements that do not satisfy the requirements of section 419A(f)(6). Those arrangements typically require large employer contributions relative to the cost of the coverage for the benefits to be provided under the plan. The plans identified in the Notice often maintain separate accounting of the assets attributable to the contributions made by each participating employer.[1] In some cases an employer's contributions are related to the claims experience of its employees, while in other cases benefits are reduced if assets derived from an employer's contributions are insufficient to fund the benefits to that employer's employees. Thus, a particular employer's contributions or its employees' benefits may be determined in a way that insulates the employer to a significant extent from the experience of other participating employers.

The arrangements described in Notice 95-34 and similar arrangements do not satisfy the requirements of section 419A(f)(6) of the Code and do not provide the tax deductions claimed by their promoters for any of several reasons. For example, such an arrangement may be providing deferred compensation; the arrangement may be separate plans maintained for each employer; or the plan may be maintaining, in form or in operation, experience-rating arrangements with respect to individual employers (e.g., where the employers have reason to expect that, at least for the most part, their contributions will benefit only their own employees). The Notice also states that even if an

[1]See Booth v. Commissioner, 108 T.C. 524 (1997), for an arrangement using a separate accounting system that does not qualify under the 10 or more employer plan exception.

arrangement satisfies the requirements of section 419A(f)(6), so that the deduction limits of sections 419 and 419A do not apply to the arrangement, the employer contributions may represent expenses that are not deductible under other sections of the Code.

Transactions that are the same as or substantially similar to the transactions described in Notice 95-34 are listed transactions for purposes of the tax shelter disclosure, registration, and list maintenance requirements. See Notice 2000-15 (2000-1 C.B. 826) (supplemented and superseded by Notice 2001-51 (2001-2 C.B. 190)), §1.6011-4(b)(2) of the Income Tax Regulations, and §§301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations.

On July 11, 2002, a notice of proposed rulemaking (REG-165868-01) relating to whether a welfare benefit fund is part of a 10 or more employer plan (as defined in section 419A(f)(6) of the Internal Revenue Code) was published in the **Federal Register** (67 FR 45933). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on November 14, 2002. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Overview of Rules

These regulations provide guidance under section 419A(f)(6) of the Code regarding the requirements that a welfare benefit fund must satisfy in order for an employer's contribution to the fund to be excepted from the rules of sections 419 and 419A.

Section 419A(f)(6) of the Code provides that sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a 10 or more employer plan that does not maintain experience-rating arrangements with respect to individual employers. A 10 or more employer plan is a plan to which more than one employer contributes and to which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers. The regulations provide that an employer is determined by aggregating all of the entities required to be aggregated under the rules under section 414(b), (c), or (m). This is particularly relevant for purposes of determining how many employers contribute, whether an employer normally contributes more than 10 percent of the total contributions under the plan, and whether the plan maintains experience-rating arrangements with respect to individual employers.

In addition, the regulations make clear that in order to be eligible for the exception from the deduction limits of sections 419 and 419A, a plan must satisfy the requirements of section 419A(f)(6) and these regulations both in form and operation. The determination of whether a plan is described in section 419A(f)(6) is based on the totality of the arrangement and all related facts and circumstances, including any related insurance contracts. Thus, all agreements and understandings (including promotional materials and policy illustrations) will be taken into account in determining whether the requirements of section 419A(f)(6) are satisfied in form and in operation. For example, if promotional materials indicate that an employer or its employees can be expected to receive a future benefit based on the employer's accumulated contributions, the plan will be treated as maintaining experience-rating arrangements with respect to individual employers, even if

the formal plan does not specifically provide for experience rating.

The regulations provide generally that a plan maintains an experience-rating arrangement with respect to an employer – making the plan ineligible for the section 419A(f)(6) exception – if any employer's cost of coverage for any period is based, in whole or in part, either on the benefits experience or on the overall experience of that employer or one or more employees of that employer. For purposes of the regulations, an employer's cost of coverage is the relationship between that employer's contributions (including those of its employees) under the plan and the benefits or other amounts payable under the plan with respect to that employer. The term benefits or other amounts payable includes all amounts payable or distributable (or that will be otherwise provided), regardless of the form of the payment or distribution. Benefits experience refers, generally, to the benefits and other amounts incurred, paid, or distributed (or otherwise provided) in the past. The overall experience of an employer is the balance that would have accumulated in a welfare benefit fund if that employer were the only employer providing benefits under the plan. The overall experience of an employee is the balance that would have accumulated in a welfare benefit fund if that employee were the only employee being provided benefits under the plan. Overall experience is defined similarly for a group of employers or a group of employees.

Definition of Experience Rating

A number of commentators suggested that the regulatory definition of experience-rating arrangement is inconsistent with industry usage and the discussions of experience rating set forth in United States v. American Bar Endowment, 477 U.S. 105 (1986) and

Sears Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992). These commentators have urged that an experience-rating arrangement be narrowly defined to include only those situations in which the employer is automatically entitled to a refund of a portion of a premium payment if claims experience is better than expected.

The IRS and Treasury have reviewed these comments and have concluded that the proposed regulatory definition of experience-rating arrangement should be retained in the final regulations. Where a Code section provides an exception from the normal tax requirements, the exception must be narrowly applied and its exclusions interpreted broadly. Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955). See also, Arkansas Best Corporation v. Commissioner, 485 U.S. 212, 219-220 (1987). Thus, the exclusion for experience-rating arrangements under the 10 or more employer plan exception should be interpreted broadly.

While both the American Bar Endowment case and the Sears case discuss a specific type of experience rating, there are other ways an insurance contract or other arrangement might take experience into account. For example, under one type of experience-rating arrangement, if the premiums paid exceed the actual cost of providing insurance to the group, the excess (the source of the dividend described in American Bar Endowment) is not refunded to the premium payer, but is instead used to reduce the cost of providing benefits for subsequent periods. This reduction in the cost of providing benefits for subsequent periods can be accomplished directly by adjusting premiums or indirectly by providing additional benefits under the arrangement at no cost to the premium payer, or through a combination of premium reductions and additional benefits.

In view of the variety of ways that an arrangement might take experience into account, the regulations provide that a plan maintains an experience-rating arrangement with respect to an individual employer if the current (or future) cost of coverage of the employer is (or will be) based on either the past benefits or other amounts paid with respect to one or more of that employer's employees (or any proxy therefor) or on the balance accumulated in the fund as a result of the employer's or its employees' past contributions (or any proxy therefor). Accordingly, the process for determining whether a plan maintains an experience-rating arrangement is to inquire whether the past experience of an individual employer or its employees is used, in whole or in part, to determine the employer's cost of coverage. This determination is not intended to be purely a computational one (although actual numbers often can be used to demonstrate the existence of an experience-rating arrangement).

Some commentators suggested that the regulations equate benefits provided to the employees of an employer with a payment to the employer and that such an equation improperly ignores the existence of the employer. This comment is based on a misreading of the regulations. The regulations reflect the fact that the provision of a benefit to an employee at no cost to the employer is, in effect, a credit to the employer that offsets the employer's otherwise applicable cost of providing that benefit. Accordingly, if the amount of such a benefit is based on the experience of the employer or its employees, the plan includes an experience-rating arrangement with respect to individual employers and is ineligible for the section 419A(f)(6) exception to sections 419 and 419A.

Use of Insurance Contracts

A number of commentators expressed concern with the results under the proposed regulations when the definition of an experience-rating arrangement was applied to a plan which provides for contributions equal to the premiums on a whole life insurance contract or other life insurance contract having level premiums. These commentators asserted that the purchase of such policies is not inconsistent with the requirements of section 419A(f)(6) and that, if the premiums under the contract are established using standardized actuarial factors (including issue age), the arrangement is not experience rated.

The final regulations retain the definition of experience rating arrangement and the general results that flow from the application of that definition to a level premium life insurance policy. This analysis recognizes that if whole life insurance contracts, or other insurance contracts that provide for level premiums or otherwise generate a savings element, are purchased under an arrangement, the economic values reflected under those contracts (including cash values, reserves, and any other economic values, such as conversion credits, high dividend rates, or the right to continue coverage at a premium that is lower than the premium that would apply in the absence of that savings element) are based on the excess of the premiums paid over the underlying mortality and related expense charges for providing the insurance and, hence, reflect the overall experience of the employers and employees who participate under the plan.

If those economic values are used to determine the current cost of coverage for that employer (as opposed to being shared among all of the employers participating in the plan), the employer can anticipate that its past contributions in excess of incurred losses

for claims for its employees will inure to the benefit of the employer or its employees (as opposed to the other employers participating in the plan). This assurance that the employer or its employees will benefit from favorable past experience is the hallmark of an experience-rating arrangement.[2]

Furthermore, Congress' expectation that employers participating in 10 or more employer plans would have no financial incentive to over-contribute was the basis for providing the section 419A(f)(6) exception from the deduction limits of sections 419 and 419A. Allowing a 10 or more employer plan to use insurance contracts with retained values, where a participating employer can benefit directly or indirectly from the retained values generated with respect to its employees (e.g., through enhanced benefits to its employees), would provide a financial incentive for the employer to over-contribute to the plan and, thus, would be contrary to the premise underlying the intent of Congress in

---

[2]The existence of experience rating in a level premium life insurance arrangement can be viewed not only from the perspective of overall experience, but also from that of claims experience. For example, assume that Employer A and Employer B have the same number of employees, and the employees of A have the same ages and other risk factors as those of B. If, on the same day in Year 1, each employer purchases from the same insurer the same amount of level premium whole life insurance coverage for each of its employees, the aggregate premium charges for A and B will be equal. Further, assume that in Year 5, A's employee who is age 60 dies, and is replaced by individual who is also age 60 and has identical risk characteristics. A purchases a new level premium whole life insurance contract of the same amount for the new employee who has an issue age of 60. A's premiums for the new 60-year-old employee will now be higher than those of B for its employee corresponding to the 60-year-old who died, because B's premiums for its 60-year-old employee are based on an issue age of 55. A's premiums for its other employees will be the same as those for B's corresponding employees. Thus, after the death of its employee, A's aggregate premium charges are higher than those of B, and this is due solely to the fact that A's employees have incurred claims in excess of the claims of B's employees.

providing the exception. This financial incentive can be seen most clearly in a flexible premium universal life contract, which is almost indistinguishable from the welfare benefit fund that Congress intended to be subject to the deduction limitations of sections 419 and 419A. The fact that the premiums on a whole life contract or other level premium arrangement are fixed ahead of time (at least with respect to individual employees) does not alter the fact that the buildup of cash value is essentially the same as the accumulation of assets in a fund. The result is the same even where there is no cash value, if the arrangement uses overpayments in earlier years to levelize the premiums. In all these cases, the retained values of life insurance contracts relating to an employer's employees are used to determine that employer's cost of coverage, and the conclusion remains that there is an experience-rating arrangement of the type not allowed by section 419A(f)(6).

Some commentators asserted that the definition of experience-rating arrangements in the proposed regulations will preclude the use of cash value life insurance under section 419A(f)(6) and will therefore eviscerate the section 419A(f)(6) exception. Neither section 419A(f)(6) nor these regulations regulate the investments of a welfare benefit fund, including investments by a trust in cash value policies. Instead, section 419A(f)(6) and the regulations are concerned with the economic relationship between a fund and participating employers, and whether the pass-through of premiums based on the insurance contracts associated with an employer's employees has the effect of creating experience-rating arrangements with respect to individual employers. Moreover, the IRS and Treasury also believe that the exception is still viable for many life and health benefit arrangements that are self-insured in accordance with the Employee Retirement Income Security Act of 1974

(ERISA) or state law. Under these types of arrangements, the employers contribute the expected cost of claims for their employees. Without the section 419A(f)(6) exception, the deduction for these contributions would be limited to the welfare benefit fund's qualified cost for the taxable year. The section 419A(f)(6) exception allows these employers to deduct those contributions without regard to whether the employees actually incurred claims.

A number of commentators cited to other provisions under sections 419 and 419A for support for their position that a plan can provide for accumulations within a welfare benefit fund that are effectively allocated to the employees without causing the plan to be ineligible for the section 419A(f)(6) exception. The Service and Treasury believe that these other provisions are not relevant in the determination of whether a plan provides an experience rating arrangement. For example, the fact that section 419(e)(4) specifically excludes certain insurance contracts (including contracts that provide experience rated refunds or policy dividends) from the definition of fund for purposes of section 419 does not necessarily mean that such contracts may be held within a welfare benefit fund while retaining the section 419A(f)(6) exception. Similarly, the fact that section 419A(c)(2) permits an additional reserve for post-retirement medical and life insurance benefits does not mean that such a reserve would not cause the plan to violate the prohibition on experience rating under section 419A(f)(6).

Special Rules of Application

The final regulations retain the special rules of application relating to insurance contracts that were set forth in the proposed regulation. For example, insurance contracts

under an arrangement are treated as assets of the fund, and the fund will be treated as having either a gain or loss with respect to those contracts.

Another special rule is provided in the case of a plan maintaining an experience-rating arrangement with respect to a group of participating employers or a group of employees covered under the plan (a rating group). Under that rule, a plan will not be treated as maintaining an experience-rating arrangement with respect to an individual employer merely because the cost of coverage under a plan with respect to the employer is based, in whole or in part, on the benefits experience or the overall experience (or a proxy for either type of experience) of a rating group that includes the employer or one or more of its employees, provided that the employer does not normally contribute more than 10 percent of all contributions with respect to that rating group. The effect of this rule is to allow the plan to provide for experience rating on a plan-wide basis or on the basis of a subset of the employers within the plan, provided that the subset of employers is not overweighted by the experience of one employer and is not defined based on the experience of the employers.

Characteristics Indicating a Plan Is Not Described in Section 419A(f)(6)

These regulations also identify five characteristics that are indications that an employer's interest with respect to the plan is more similar to the relationship of an individual employer to a fund than an insured to an insurer. (See, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984), 1984-3 C.B. (Vol. 2) 1, 413.) The presence of some of these characteristics in a plan suggests that there are multiple plans present instead of a single plan. The presence of others tends to indicate that an employer's cost of coverage

is (or will be) based on that employer's benefits experience. Others tend to indicate that the plan is expected to accumulate a surplus that ultimately will be used for the benefit of the individual employers (or their employees). One way this surplus might be used would be to reduce future contributions for the individual employers based on past contributions or claims of the employers. Another way would be to pay benefits to an employer's employees based on the employer's share of the surplus on the occasion of the withdrawal of the employer or at plan termination, thereby violating the rule that an employer's cost of coverage cannot be based on its overall experience. Accordingly, these regulations provide that a plan exhibiting any of these characteristics is not a 10 or more employer plan described in section 419A(f)(6) unless it is established to the satisfaction of the Commissioner that the plan satisfies the requirements of section 419A(f)(6) and these proposed regulations. It should be noted that the fact that a plan has none of these characteristics does not create an inference that it is a 10 or more employer plan described in section 419A(f)(6).

The first, third and fourth characteristics under the proposed regulations indicating that a plan is not a 10 or more employer plan described in section 419A(f)(6) (i.e., the assets of the plan are allocated among the participating employers through a separate accounting of contributions and expenditures for individual employers or otherwise, the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed price or the plan charges the participating employers an unreasonably high amount for the covered risk) have been retained without change.

The second characteristic under the proposed regulations indicating that a plan is

not a 10 or more employer plan described in section 419A(f)(6) is that amounts charged under the plan differ among the employers in a manner that is not reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers (such as age, gender, dependents covered, geographic locale, or benefit terms). In response to comments, this second characteristic has been clarified so that the exception for reflection of differences in risk or rating factors commonly taken into account in manual rates is limited to differences in charges that are merely reflective of differences in current risk (such as current age, gender, dependents covered, geographic locale, or benefit terms). Accordingly, an arrangement that charges different amounts for life insurance based on issue age would exhibit this second characteristic, unless the differences in amount charged are merely reflective of differences in risk or rating factors at the current age (e.g., reflecting select and ultimate mortality).

The fifth characteristic under the proposed regulation indicating that a plan is not a 10 or more employer plan described in section 419A(f)(6) is that benefits or other amounts payable can be provided upon triggering events other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary termination of employment. A number of commentators expressed concern that this fifth characteristic effectively prohibits a termination of a welfare benefit arrangement or otherwise redefines what is a welfare benefit arrangement. This concern reflects a misreading of the regulations, as this fifth characteristic does not prohibit the payment of benefits upon

termination of the arrangement or withdrawal of an employer from the arrangement[3] or in any other way seek to redefine what is a permitted welfare benefit. Instead the characteristic reflects the inherent difficulty an insurer would have in determining an actuarially appropriate price for providing fixed benefits on the occasion of these non-standard benefit triggers and the associated likelihood that the amount of the benefits payable on such an occasion is being determined based on the overall experience of the employee or employer. The fact that some commentators have suggested that an employer be able to "spin-off" the employer's "share" of a fund is further indication that many plans that purport to fit within the section 419A(f)(6) exception are engaging in prohibited experience rating.

Taxpayers are reminded that a plan that exhibits one of these characteristics may still establish that the plan satisfies the requirements of section 419A(f)(6). For example, in the case of a plan that provides for a benefit to be provided on the occasion of an employer's withdrawal from the plan, the plan would have to demonstrate that the amount provided to an employee is not based on the benefits experience or the overall experience of the employee or the employer. In addition, in response to comments, the final regulations clarify that a plan does not exhibit this fifth characteristic merely because, upon cessation of participation in the plan, an employee is provided with the right to convert coverage under a group life insurance contract to coverage under an individual life insurance contract without demonstrating evidence of insurability, but only if there is no

---

[3]A withdrawal of an employer merely terminates the arrangement for that employer, but it continues for the other employers.

additional economic value associated with the conversion right.

The examples in the proposed regulations illustrating the application of the rules regarding experience-rating arrangements to specific fact situations are included in the final regulations, with minor changes, and two additional examples have been included. The facts described in some of the examples illustrate arrangements that do not maintain experience-rating arrangements with respect to individual employers. Other examples, however, describe arrangements that exhibit the characteristics of a fund that Congress intended to be subject to the deduction limitations of sections 419 and 419A. Each example illustrates only the application of the definition of experience-rating arrangements under section 419A(f)(6) and these regulations, and no inference should be drawn from the scope of the examples about whether these plans are otherwise described in section 419A(f)(6) or about any other provision of the Code.[4]

Pursuant to the authority set forth in section 419A(i), the regulations provide a special rule to assist participating employers and the Commissioner in verifying that the arrangement satisfies the section 419A(f)(6) requirements. Under that rule, an arrangement satisfies the requirements of section 419A(f)(6) and the regulations only if the plan is maintained pursuant to a written document that (1) requires the plan administrator

---

[4]For example, in Neonatology Associates, P.A., v. Commissioner, 299 F.3d 221 (3d Cir. 2002), affirming 115 T.C. 43 (2000), the Court held that the contributions were in a large part constructive dividends to the employee/owners (and thus did not reach the government's alternative contention that the plan was maintaining experience-rating arrangements with respect to individual employers). In Booth v. Commissioner, 108 T.C. 524 (1997), the Tax Court held that the arrangement was an aggregation of separate plans (and thus was not a single plan) and that there were experience-rating arrangements with respect to the individual employers.

to maintain records sufficient for the Commissioner or any participating employer to readily verify the plan's compliance with section 419A(f)(6) and (2) provides the Commissioner and each participating employer with the right to inspect and copy all such records.

Effective Date

Except as explained below, these regulations -- which generally clarify existing law -- are effective for contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002. For contributions made before this effective date, the IRS will continue applying existing law, including the analysis set forth in Notice 95-34 and relevant case law. Thus, taxpayers should not infer that a contribution that would be nondeductible under the regulations would be deductible if made before that date. In this regard, taxpayers are reminded that the IRS has already identified transactions that are the same as or substantially similar to the transactions described in Notice 95-34 as listed transactions for purposes of §1.6011-4T(b)(2) of the Temporary Income Tax Regulations and §301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations.

The requirement that written plan documents contain specified provisions relating to compliance information and the record maintenance requirement for plan administrators are effective for taxable years of a welfare benefit fund beginning after July 17, 2003. Existing record retention requirements and record production requirements under section 6001 continue to apply to employers and promoters.

Special Analyses

It has been determined that these regulations are not a significant regulatory action for purposes of Executive Order 12866. Accordingly, a regulatory assessment is not required. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The collections of information in the regulation are in §1.419A(f)(6)-1(a)(2) and (e) and consist of the requirements that a plan administrator maintain certain information and that it provide that information upon request to the Commissioner and to employers participating in the plan. This certification is based on the fact that requests for such information are likely to be made, on average, less than once per year per employer and that the costs of maintaining and providing this information are small. In addition, relatively few small entities are plan administrators. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was sent to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Betty J. Clary, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§1.419A(f)(6)-1 is also issued under 26 U.S.C. 419A(i). * * *

Par. 2. Section 1.419A(f)(6)-1 is added to read as follows:

§1.419A(f)(6)-1 Exception for 10 or more employer plan

(a) Requirements--(1) In general. Sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a 10 or more employer plan described in section 419A(f)(6). A plan is a 10 or more employer plan described in section 419A(f)(6) only if it is a single plan--

(i) To which more than one employer contributes;

(ii) To which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers;

(iii) That does not maintain an experience-rating arrangement with respect to any individual employer; and

(iv) That satisfies the requirements of paragraph (a)(2) of this section.

(2) Compliance information. A plan satisfies the requirements of this paragraph

(a)(2) if the plan is maintained pursuant to a written document that requires the plan administrator to maintain records sufficient for the Commissioner or any participating employer to readily verify that the plan satisfies the requirements of section 419A(f)(6) and this section and that provides the Commissioner and each participating employer (or a person acting on the participating employer's behalf) with the right, upon written request to the plan administrator, to inspect and copy all such records. See §1.414(g)-1 for the definition of plan administrator.

(3) Application of rules--(i) In general. The requirements described in paragraph (a)(1) and (2) of this section must be satisfied both in form and in operation.

(ii) Arrangement is considered in its entirety. The determination of whether a plan is a 10 or more employer plan described in section 419A(f)(6) is based on the totality of the arrangement and all related facts and circumstances, including any related insurance contracts. Accordingly, all agreements and understandings (including promotional materials and policy illustrations) and the terms of any insurance contract will be taken into account in determining whether the requirements are satisfied in form and in operation.

(b) Experience-rating arrangements--(1) General rule. A plan maintains an experience-rating arrangement with respect to an individual employer and thus does not satisfy the requirement of paragraph (a)(1)(iii) of this section if, with respect to that employer, there is any period for which the relationship of contributions under the plan to the benefits or other amounts payable under the plan (the cost of coverage) is or can be expected to be based, in whole or in part, on the benefits experience or overall experience (or a proxy for either type of experience) of that employer or one or more employees of that

employer. For purposes of this paragraph (b)(1), an employer's contributions include all contributions made by or on behalf of the employer or the employer's employees. See paragraph (d) of this section for the definitions of benefits experience, overall experience, and benefits or other amounts payable. The rules of this paragraph (b) apply under all circumstances, including employer withdrawals and plan terminations.

(2) Adjustment of contributions. An example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan that entitles an employer to (or for which the employer can expect) a reduction in future contributions if that employer's overall experience is positive. Similarly, a plan maintains an experience-rating arrangement with respect to an individual employer where an employer can expect its future contributions to be increased if the employer's overall experience is negative. A plan also maintains an experience-rating arrangement with respect to an individual employer where an employer is entitled to receive (or can expect to receive) a rebate of all or a portion of its contributions if that employer's overall experience is positive or, conversely, where an employer is liable to make additional contributions if its overall experience is negative.

(3) Adjustment of benefits. An example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan under which benefits for an employer's employees are (or can be expected to be) increased if that employer's overall experience is positive or, conversely, under which benefits are (or can be expected to be) decreased if that employer's overall experience is negative. A plan also maintains an experience-rating arrangement with respect to an individual employer if benefits for an

employer's employees are limited by reference, directly or indirectly, to the overall experience of the employer (rather than having all the plan assets available to provide the benefits).

(4) Special rules--(i) Treatment of insurance contracts--(A) In general. For purposes of this section, insurance contracts under the arrangement will be treated as assets of the fund. Accordingly, the value of the insurance contracts (including non-guaranteed elements) is included in the value of the fund, and amounts paid between the fund and the insurance company are disregarded, except to the extent they generate gains or losses as described in paragraph (b)(4)(i)(C) of this section.

(B) Payments to and from an insurance company. Payments from a participating employer or its employees to an insurance company pursuant to insurance contracts under the arrangement will be treated as contributions made to the fund, and amounts paid under the arrangement from an insurance company will be treated as payments from the fund.

(C) Gains and losses from insurance contracts. As of any date, if the sum of the benefits paid by the insurer and the value of the insurance contract (including non-guaranteed elements) is greater than the cumulative premiums paid to the insurer, the excess is treated as a gain to the fund. As of any date, if the cumulative premiums paid to the insurer are greater than the sum of the benefits paid by the insurer and the value of the insurance contract (including non-guaranteed elements), the excess is treated as a loss to the fund.

(ii) Treatment of flexible contribution arrangements. Solely for purposes of determining the cost of coverage under a plan, if contributions for any period can vary with

respect to a benefit package, the Commissioner may treat the employer as contributing the minimum amount that would maintain the coverage for that period.

(iii) Experience rating by group of employers or group of employees. A plan will not be treated as maintaining an experience-rating arrangement with respect to an individual employer merely because the cost of coverage under the plan with respect to the employer is based, in whole or in part, on the benefits experience or the overall experience (or a proxy for either type of experience) of a rating group, provided that no employer normally contributes more than 10 percent of all contributions with respect to that rating group. For this purpose, a rating group means a group of participating employers that includes the employer or a group of employees covered under the plan that includes one or more employees of the employer.

(iv) Family members, etc. For purposes of this section, contributions with respect to an employee include contributions with respect to any other person (e.g., a family member) who may be covered by reason of the employee's coverage under the plan and amounts provided with respect to an employee include amounts provided with respect to such a person.

(v) Leased employees. In the case of an employer that is the recipient of services performed by a leased employee described in section 414(n)(2) who participates in the plan, the leased employee is treated as an employee of the recipient and contributions made by the leasing organization attributable to service performed with the recipient are treated as made by the recipient.

(c) Characteristics indicating a plan is not a 10 or more employer plan--(1) In

general. The presence of any of the characteristics described in paragraphs (c)(2) through (c)(6) of this section generally indicates that the plan is not a 10 or more employer plan described in section 419A(f)(6). Accordingly, unless established to the satisfaction of the Commissioner that the plan satisfies the requirements of section 419A(f)(6) and this section, a plan having any of the following characteristics is not a 10 or more employer plan described in section 419A(f)(6). A plan's lack of all the following characteristics does not create any inference that the plan is a 10 or more employer plan described in section 419A(f)(6).

(2) Allocation of plan assets. Assets of the plan or fund are allocated to a specific employer or employers through separate accounting of contributions and expenditures for individual employers, or otherwise.

(3) Differential pricing. The amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers (such as current age, gender, geographic locale, number of covered dependents, and benefit terms) for the particular benefit or benefits being provided.

(4) No fixed welfare benefit package. The plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost, within the meaning of paragraph (d)(5) of this section.

(5) Unreasonably high cost. The plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, but that cost is unreasonably high for the covered risk for the plan as a whole.

(6) Nonstandard benefit triggers. Benefits or other amounts payable can be paid, distributed, transferred, or otherwise provided from a fund that is part of the plan by reason of any event other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary separation from employment. Thus, for example, a plan exhibits this characteristic if the plan provides for the payment of benefits or the distribution of an insurance contract to an employer's employees on the occasion of the employer's withdrawal from the plan. A plan will not be treated as having the characteristic described in this paragraph merely because, upon cessation of participation in the plan, an employee is provided with the right to convert coverage under a group life insurance contract to coverage under an individual life insurance contract without demonstrating evidence of insurability, but only if there is no additional economic value associated with the conversion right.

(d) Definitions. For purposes of this section:

(1) Benefits or other amounts payable. The term benefits or other amounts payable includes all amounts that are payable or distributable (or that will be otherwise provided) directly or indirectly to employers, to employees or their beneficiaries, or to another fund as a result of a spinoff or transfer, and without regard to whether payable or distributable as welfare benefits, cash, dividends, rebates of contributions, property, promises to pay, or otherwise.

(2) Benefits experience. The benefits experience of an employer (or of an employee or a group of employers or employees) means the benefits and other amounts incurred, paid, or distributed (or otherwise provided) directly or indirectly, including to

another fund as a result of a spinoff or transfer, with respect to the employer (or employee or group of employers or employees), and without regard to whether provided as welfare benefits, cash, dividends, credits, rebates of contributions, property, promises to pay, or otherwise.

(3) Overall experience--(i) Employer's overall experience. The term overall experience means, with respect to an employer (or group of employers), the balance that would have accumulated in a welfare benefit fund if that employer (or those employers) were the only employer (or employers) providing welfare benefits under the plan. Thus, the overall experience is credited with the sum of the contributions under the plan with respect to that employer (or group of employers), less the benefits and other amounts paid or distributed (or otherwise provided) with respect to that employer (or group of employers) or the employees of that employer (or group of employers), and adjusted for gain or loss from insurance contracts (as described in paragraph (b)(4)(i) of this section), investment return, and expenses. Overall experience as of any date may be either a positive or a negative number.

(ii) Employee's overall experience. The term overall experience means, with respect to an employee (or group of employees, whether or not employed by the same employer), the balance that would have accumulated in a welfare benefit fund if the employee (or group of employees) were the only employee (or employees) being provided welfare benefits under the plan. Thus, the overall experience is credited with the sum of the contributions under the plan with respect to that employee (or group of employees), less the benefits and other amounts paid or distributed (or otherwise provided) with respect to

that employee (or group of employees), and adjusted for gain or loss from insurance contracts (as described in paragraph (b)(4)(i) of this section), investment return, and expenses. Overall experience as of any date may be either a positive or a negative number.

(4) Employer. The term employer means the employer whose employees are participating in the plan and those employers required to be aggregated with the employer under section 414(b), (c), or (m).

(5) Fixed welfare benefit package--(i) In general. A plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, if it--

(A) Defines one or more welfare benefits, each of which has a fixed amount that does not depend on the amount or type of assets held by the fund;

(B) Specifies fixed contributions to provide for those welfare benefits; and

(C) Specifies a coverage period during which the plan agrees to provide specified welfare benefits, subject to the payment of the specified contributions by the employer.

(ii) Treatment of actuarial gains or losses. A plan will not be treated as failing to provide for fixed welfare benefits for a fixed coverage period for a fixed cost merely because the plan does not pay the promised benefits (or requires all participating employers to make proportionate additional contributions based on the fund's shortfall) when there are insufficient assets under the plan to pay the promised benefits. Similarly, a plan will not be treated as failing to provide for fixed welfare benefits for a fixed coverage period for a fixed cost merely because the plan provides a period of extended coverage after the end of the coverage period with respect to employees of all participating

employers at no cost to the employers (or provides a proportionate refund of contributions to all participating employers) because of the plan-wide favorable actuarial experience during the coverage period.

(e) Maintenance of records. The plan administrator of a plan that is intended to be a 10 or more employer plan described in section 419A(f)(6) shall maintain permanent records and other documentary evidence sufficient to substantiate that the plan satisfies the requirements of section 419A(f)(6) and this section. (See §1.414(g)-1 for the definition of plan administrator.)

(f) Examples. The provisions of paragraph (c) of this section and the provisions of section 419A(f)(6) and this section relating to experience-rating arrangements may be illustrated by the following examples. Unless stated otherwise, it should be assumed that any life insurance contract described in an example is non-participating and has no value other than the value of the policy's current life insurance protection plus its cash value, and that no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers. Paragraph (ii) of each example applies the characteristics listed in paragraph (c) of this section to the facts described in that example. Paragraphs (iii) and (iv) of each example analyze the facts described in the example to determine whether the plan maintains experience-rating arrangements with respect to individual employers. Paragraphs (iii) and (iv) of each example illustrate only the meaning of experience-rating arrangements. No inference should be drawn from these examples about whether these plans are otherwise described in section 419A(f)(6) or about the applicability or nonapplicability of any other Internal Revenue Code provision that may limit

or deny the deduction of contributions to the arrangements. Further, no inference should be drawn from the examples concerning the tax treatment of employees as a result of the employer contributions or the provision of the benefits. The examples are as follows:

Example 1. (i) An arrangement provides welfare benefits to employees of participating employers. Each year a participating employer is required to contribute an amount equal to the claims and other expenses expected with respect to that employer for the year (based on current age, gender, geographic locale, number of participating employees, benefit terms, and other risk or rating factors commonly taken into account in manual rates used by insurers for the benefits being provided), multiplied by the ratio of actual claims with respect to that employer for the previous year over the expected claims with respect to that employer for the previous year.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Differential pricing exists under this arrangement because the amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) This arrangement does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Under the arrangement, an employer's cost of coverage for each year is based, in part, on that employer's benefits experience (i.e., the benefits and other amounts provided in the past with respect to one or more employees of that employer). Accordingly, pursuant to paragraph (b)(1) of this section, the arrangement maintains experience-rating arrangements with respect to individual employers.

Example 2. (i) The facts are the same as in Example 1, except that the amount charged to an employer each year is equal to claims and other expenses expected with respect to that employer for the year (determined the same as in Example 1), multiplied by the ratio of actual claims for the previous year (determined on a plan-wide basis) over the expected claims for the previous year (determined on a plan-wide basis).

(ii) Based on the limited facts described above, this arrangement exhibits none of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Unlike the arrangement discussed in Example 1, there is no differential pricing under the arrangement because the only differences in the amounts charged to the employers are solely reflective of differences in current risk or rating factors that are commonly taken into

account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) Nothing in the facts described in this Example 2 indicates that the arrangement maintains experience-rating arrangements prohibited under section 419A(f)(6) and this section. An employer's cost of coverage under the arrangement is based, in part, on the benefits experience of that employer (as well as of all the other participating employers). However, pursuant to paragraph (b)(4)(iii) of this section, the arrangement will not be treated as maintaining experience-rating arrangements with respect to the individual employers merely because the employers' cost of coverage is based on the benefits experience of a group of employees eligible under the plan, provided no employer normally contributes more than 10 percent of all contributions with respect to the rating group that includes the employees of an individual employer. Under the arrangement described in this Example 2, the rating group includes all the participating employers (or all of their employees), and no employer normally contributes more than 10 percent of the contributions made under the arrangement by all the employers. Accordingly, absent other facts, the arrangement will not be treated as maintaining experience-rating arrangements with respect to individual employers.

Example 3. (i) Arrangement A provides welfare benefits to employees of participating employers. Each year an employer is required to contribute an amount equal to the claims and other expenses expected with respect to that employer for the year (based on current risk or rating factors commonly taken into account in manual rates used by insurers for the benefits being provided), adjusted based on the employer's notional account. An employer's notional account is determined as follows. The account is credited with the sum of the employer's contributions previously paid under the plan less the benefit claims for that employer's employees. The notional account is further increased by a fixed five percent investment return (regardless of the actual investment return earned on the funds). If an employer's notional account is positive, the employer's contributions are reduced by a specified percentage of the notional account. If an employer's notional account is negative, the employer's contributions are increased by a specified percentage of the notional account.

(ii) Arrangement A exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets under the plan are allocated to specific employers. Second, differential pricing exists because the amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) Arrangement A does not satisfy the requirements of section 419A(f)(6) and this

section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Under the arrangement, a participating employer's cost of coverage for each year is based on a proxy for that employer's overall experience. An employer's overall experience, as that term is defined in paragraph (d)(3) of this section, includes the balance that would have accumulated in the fund if that employer's employees were the only employees being provided benefits under the plan. Under that definition, the overall experience is credited with the sum of the contributions paid under the plan by or on behalf of that employer less the benefits or other amounts provided to with respect to that employer's employees, and adjusted for gain or loss from insurance contracts, expenses, and investment return. Under the formula used by the arrangement in this example to determine employer contributions, expenses are disregarded and a fixed investment return of five percent is used instead of actual investment return. The disregard of expenses and substitution of the fixed investment return for the actual investment return merely results in an employer's notional account that is a proxy for the overall experience of that employer. Accordingly, the arrangement maintains experience-rating arrangements with respect to individual employers.

Example 4. (i) Under Arrangement B, death benefits are provided for eligible employees of each participating employer. Individual level premium whole life insurance policies are purchased to provide the death benefits. Each policy has a face amount equal to the death benefit payable with respect to the individual employee. Each year, a participating employer is charged an amount equal to the level premiums payable with respect to the employees of that employer. One participating employer, F, has an employee, P, whose coverage under the arrangement commenced at the beginning of 2000, when P was age 50. P is covered under the arrangement for $1 million of death benefits, and a life insurance policy with a face amount of $1 million has been purchased on P's life. The level annual premium on the policy is $23,000. At the beginning of 2005, when P is age 55, the $23,000 premium amount has been paid for five years and the policy, which continues to have a face amount of $1 million, has a cash value of $92,000. Another employer, G, has an employee, R, who is also 55 years old at the beginning of 2005 and is covered under Arrangement B for $1 million, for which a level premium life insurance policy with a face amount of $1 million has been purchased. However, R did not become covered under Arrangement B until the beginning of 2005. Because R's coverage began at age 55, the level annual premium charged for the policy on R's life is $30,000, or $7,000 more than the premiums payable on the policy in effect on P's life. Employer F is charged $23,000 and employer G is charged $30,000 for the death benefit for employees P and R, respectively. Assume that employees P and R are the only covered employees of their respective employers and that they are identical with respect to current risk and rating factors that are commonly taken into account in manual rates used by insurers for death benefits.

(ii) Arrangement B exhibits at least three of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer

plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, there is differential pricing under the arrangement. That is, the amount charged under the plan during the year for a specific amount of death benefit coverage is not the same for all the employers (employer F is charged $23,000 each year for $1 million of death benefit coverage while employer G is charged $30,000 each year for the same coverage), and the difference is not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the death benefit being provided. (The differences in amounts charged are attributable to differences in issue age and not to differences in current risk or rating factors, as employees P and R are the same age). Third, during the early years of the arrangement, the amounts charged are unreasonably high for the covered risk for the plan as a whole.

(iii) Arrangement B does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement B maintains experience-rating arrangements with respect to individual employers because the cost of coverage for each year for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under Arrangement B, employer F's cost of coverage for 2005 is $23,000 for $1 million of coverage. The $92,000 cash value at the beginning of 2005 in the policy insuring P's life is a proxy for employer F's overall experience. (The $92,000 is essentially the balance that would have accumulated in the fund if employer F were the only employer providing welfare benefits under Arrangement B.) Further, the $23,000 charged to F for the $1 million of coverage in 2005 is based on the $92,000 since, in the absence of the $92,000, employer F would have been charged $30,000 for P's $1 million death benefit coverage. (Note that the conclusion that the $92,000 balance is the basis for the lower premium charged to employer F is consistent with the fact that a $92,000 balance, if converted to a life annuity using the same actuarial assumptions as were used to calculate the cash value amount, would be sufficient to provide for annual annuity payments of $7,000 for the life of P -- an amount equal to the $7,000 difference from the premium charged in 2005 to employer G for the $1 million of coverage on employee R's life.) Thus, F's cost of coverage for 2005 is based on a proxy for F's overall experience. Accordingly, Arrangement B maintains an experience-rating arrangement with respect to employer F.

(iv) Arrangement B also maintains an experience-rating arrangement with respect to employer G because it can be expected that each year G will be charged $30,000 for the $1 million of coverage on R's life. Each year, G's cost of coverage will reflect G's prior contributions and allocable earnings, so that G's cost of coverage will be based on a proxy for G's overall experience. Accordingly, Arrangement B maintains an experience-rating arrangement with respect to employer G. Similarly, Arrangement B maintains an experience-rating arrangement with respect to each other participating employer. Accordingly, Arrangement B maintains experience-rating arrangements with respect to individual employers. This would also be the result if Arrangement B maintained an experience-rating arrangement with respect to only one individual employer.

Example 5. (i) The facts are the same as in Example 4 except that the death benefits are provided under 10-year level term life insurance policies. One participating employer, H, has an employee, M, whose coverage under the arrangement commenced at the beginning of 2000, when M was age 35. M is covered under the arrangement for $1 million of death benefits, and a 10-year level term life insurance policy with a face amount of $1 million has been purchased on M's life. The level annual premium on the policy for the first 10 years is $700. At the beginning of 2007, when M is age 42, the $700 premium amount has been paid for seven years. Another employer, J, has an employee, N, who is also 42 years old at the beginning of 2007 and is covered under the arrangement for $1 million, for which a 10-year level term life insurance policy with a face amount of $1 million has been purchased. However, N did not become covered under the arrangement until the beginning of 2007. Because N's coverage began at age 42, the 10-year level term premium charged for the policy on N's life is $1,100, or $400 more than the premiums then payable on the policy in effect on M's life. Neither the policy on employee M nor the policy on employee N has any cash value at any point during its term. Assume that employees M and N are the only covered employees of their respective employers and that they are identical with respect to any current risk and rating factors that are commonly taken into account in manual rates used by insurers for the death benefit being provided.

(ii) Based on the facts described in this Example 5, this arrangement exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, for the same reasons as described in paragraph (ii) of Example 4, there is differential pricing under the arrangement. Second, assets of the plan are effectively allocated to specific employers. This is the case even though the insurance policies used by employers H and J have no accessible cash value.

(iii) The facts described in this Example 5 indicate that the arrangement does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. This arrangement maintains experience-rating arrangements with respect to individual employers because the cost of coverage for each year for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under this arrangement employer H's cost of coverage in 2007 is $700 for $1 million of coverage. Although the policy insuring M's life has no cash value accessible to employer H, the accumulation of the excesses of the amounts paid by employer H on behalf of employee M over each year's underlying mortality and expense charges for providing life insurance coverage to employee M provide economic value to employer H (i.e., the ability to purchase future coverage on M's life at a premium that is less than the underlying mortality and expense charges as those underlying charges increase with M's increasing age). Thus, H's cost of coverage for 2007 is based on a proxy for H's overall experience. Accordingly, this arrangement maintains an experience-rating arrangement with respect to employer H.

(iv) This arrangement also maintains an experience-rating arrangement with respect to employer J because it can be expected that for each of the next nine years J will be charged $1,100 for the $1 million of coverage on N's life. Each year, J's cost of coverage will reflect J's prior contributions, so that J's cost of coverage will be based on a proxy for J's overall experience. Accordingly, this arrangement maintains an experience-rating arrangement with respect to employer J. Similarly, this arrangement maintains an experiencing-rating arrangement with respect to each other participating employer. Accordingly, this arrangement maintains experience-rating arrangements with respect to individual employers. This would also be the result if this arrangement maintained an experience-rating arrangement with respect to only one individual employer.

Example 6. (i) Under Arrangement C, death benefits are provided for eligible employees of each participating employer. Flexible premium universal life insurance policies are purchased to provide the death benefits. Each policy has a face amount equal to the death benefit payable with respect to the individual employee. Each participating employer can make any contributions to the arrangement provided that the amount paid for each employee is at least the amount needed to prevent the lapse of the policy. The amount needed to prevent the lapse of the universal life insurance policy is the excess, if any, of the mortality and expense charges for the year over the policy balance. All contributions made by an employer are paid as premiums to the universal life insurance policies purchased on the lives of the covered employees of that employer. Participating employers S and V each have a 50-year-old employee covered under Arrangement C for death benefits of $1 million, which is the face amount of the respective universal life insurance policies on the lives of the employees. In the first year of coverage employer S makes a contribution of $23,000 (the amount of a level premium) while employer V contributes only $6,000, which is the amount of the mortality and expense charges for the first year. At the beginning of year two, the balance in employer S's policy (including earnings) is $18,000, but the balance in V's policy is zero. Although S is not required to contribute anything in the second year of coverage, S contributes an additional $15,000 in the second year. Employer V contributes $7,000 in the second year.

(ii) Arrangement C exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, the arrangement does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost.

(iii) Arrangement C does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement C maintains experience-rating arrangements with respect to individual employers because the cost of coverage of an employer participating in the arrangement is based on a proxy for the overall experience of that employer. Pursuant to paragraph (b)(4)(ii) of this section (concerning treatment of flexible contribution

arrangements), solely for purposes of determining an employer's cost of coverage, the Commissioner may treat an employer as contributing the minimum amount needed to maintain the coverage. Applying this treatment, H's cost of coverage for the first year of coverage under Arrangement C is $6,000 for $1 million of death benefit coverage, but for the second year it is zero for the same amount of coverage because that is the minimum amount needed to keep the insurance policy from lapsing. Employer H's overall experience at the beginning of the second year of coverage is $18,000, because that is the balance that would have accumulated in the fund if H were the only employer providing benefits under Arrangement C. (The special rule of paragraph (b)(4)(ii) of this section only applies to determine cost of coverage; it does not apply in determining overall experience.) The $18,000 balance in the policy insuring the life of employer H's employee is a proxy for H's overall experience. Employer H can choose not to make any contributions in the second year of coverage due to the $18,000 policy balance. Thus, H's cost of coverage for the second year is based on a proxy for H's overall experience. Accordingly, Arrangement C maintains an experience-rating arrangement with respect to employer H.

(iv) Arrangement C also maintains an experience-rating arrangement with respect to employer J because in each year J can contribute more than the amount needed to prevent a lapse of the policy on the life of its employee and can expect that its cost of coverage for subsequent years will reflect its prior contributions and allocable earnings. Accordingly, Arrangement C maintains an experience-rating arrangement with respect to employer J.

Example 7. (i) Arrangement D provides death benefits for eligible employees of each participating employer. Each employer can choose to provide a death benefit of either one, two, or three times the annual compensation of the covered employees. Under Arrangement D, the death benefit is payable only if the employee dies while employed by the employer. If an employee terminates employment with the employer or if the employer withdraws from the arrangement, the death benefit is no longer payable, no refund or other credit is payable to the employer or to the employees, and no policy or other property is transferrable to the employer or the employees. Furthermore, the employees are not provided with any right under Arrangement D to coverage under any other arrangement, nor with any right to purchase or to convert to an individual insurance policy, other than any conversion rights the employees may have in accordance with state law (and which provide no additional economic benefit). Arrangement D determines the amount required to be contributed by each employer for each month of coverage by aggregating the amount required to be contributed for each covered employee of the employer. The amount required to be contributed for each covered employee is determined by multiplying the amount of the death benefit coverage (in thousands) for the employee by five-year age bracket rates in a table specified by the plan, which is used uniformly for all covered employees of all participating employers. The rates in the specified table do not exceed the rates set forth in Table I of §1.79-3(d)(2), and differences in the rates in the table are

merely reflective of differences in mortality risk for the various age brackets. The rates in the table are not based in whole or in part on the experience of the employers participating in Arrangement D. Arrangement D uses the amount contributed by each employer to purchase one-year term insurance coverage on the lives of the covered employees with a face amount equal to the death benefit provided by the plan. No employer is entitled to any rebates or refunds provided under the insurance contract.

(ii) Arrangement D does not exhibit any of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Under Arrangement D, assets are not allocated to a specific employer or employers. Differences in the amounts charged to the employers are solely reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided. The arrangement provides for fixed welfare benefits for a fixed coverage period for a fixed cost, within the meaning of paragraph (d)(5) of this section. The cost charged under the arrangement is not unreasonably high for the covered risk of the plan as a whole. Finally, benefits and other amounts payable can be paid, distributed, transferred, or otherwise made available only by reason of the death of the employee, so that there is no nonstandard benefit trigger under the arrangement.

(iii) Nothing in the facts of this Example 7 indicates that Arrangement D fails to satisfy the requirements of section 419A(f)(6) or this section by reason of maintaining experience-rating arrangements with respect to individual employers. Based solely on the facts described above, Arrangement D does not maintain an experience rating-arrangement with respect to any individual employer because for each participating employer there is no period for which the employer's cost of coverage under the arrangement is based, in whole or in part, on either the benefits experience or the overall experience (or a proxy for either type of experience) of that employer or its employees.

Example 8. (i) The facts are the same as in Example 7, except that under the arrangement, any refund or rebate provided under that year's insurance contract is allocated among all the employers participating in the arrangement in proportion to their contributions, and is used to reduce the employers' contributions for the next year.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). The arrangement includes nonstandard benefit triggers because amounts are made available to an employer by reason of the insurer providing a refund or rebate to the plan, an event that is other than the illness, personal injury, or death of an employee or family member, or an employee's involuntary separation from employment.

(iii) Based on the limited and specific facts described in this Example 8, an

employer participating in this arrangement should be able to establish to the satisfaction of the Commissioner that the plan does not maintain experience-rating arrangements with respect to individual employers. A participating employer's cost of coverage is the relationship of its contributions to the death benefit coverage or other amounts payable with respect to that employer, including the employer's portion of the insurance company rebate and refund amounts. The rebate and refund amounts are allocated to an employer based on that employer's contribution for the prior year. However, even though an employer's overall experience includes its past contributions, contributions alone are not a proxy for an employer's overall experience under the particular facts described in this Example 8. As a result, a participating employer's cost of coverage under the arrangement for each year (or any other period) is not based on that employer's benefits experience or its overall experience (or a proxy for either type of experience), except as follows: If the total of the insurance company refund or rebate amounts is a proxy for the overall experience of all participating employers, a participating employer's cost of coverage will be based in part on that employer's overall experience (or a proxy therefor) by reason of that employer's overall experience being a portion of the overall experience of all participating employers. Under the special rule of paragraph (b)(2)(iii) of this section, however, that fact alone will not cause the arrangement to be treated as maintaining an experience-rating arrangement with respect to an individual employer because no employer normally contributes more than 10 percent of the total contributions under the plan by all employers (the rating group). Accordingly, the arrangement will not be treated as maintaining experience-rating arrangements with respect to individual employers.

Example 9. (i) Arrangement E provides medical benefits for covered employees of 90 participating employers. The level of medical benefits is determined by a schedule set forth in the trust document and does not vary by employer. Other than any rights an employee may have to COBRA continuation coverage, the medical benefits cease when an employee terminates employment with the employer. If an employer withdraws from the arrangement, there is no refund of any contributions and there is no transfer of anything of value to employees of the withdrawing employer, to the withdrawing employer, or to another plan or arrangement maintained by the withdrawing employer. Arrangement E determines the amount required to be contributed by each employer for each year of coverage, and the aggregate amounts charged are not unreasonably high for the covered risk for the plan as a whole. To determine the amount to be contributed for each employer, Arrangement E classifies an employer based on the employer's location. These geographic areas are not changed once established under the arrangement. The amount charged for the coverage under the arrangement to the employers in a geographic area is determined from a rate-setting manual based on the benefit package and geographic area, and differences in the rates in the manual are merely reflective of current differences in those risk or rating factors. The rates in the rate-setting manual are not based in whole or in part on the experience of the employers participating in Arrangement E.

(ii) Arrangement E does not exhibit any of the characteristics listed in paragraph (c)

of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Although the amounts charged under the arrangement to an employer in one geographic area can be expected to differ from those charged to an employer in another geographic area, the differences are merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for medical benefits.

(iii) Nothing in the facts of this Example 9 indicates that Arrangement E fails to satisfy the requirements of section 419A(f)(6) or this section by reason of maintaining experience-rating arrangements with respect to individual employers. Based solely on the facts described above, Arrangement E does not maintain an experience rating-arrangement with respect to any individual employer because for each participating employer there is no period for which the employer's cost of coverage under the arrangement is based, in whole or in part, on either the benefits experience or the overall experience (or a proxy for either type of experience) of that employer or its employees.

Example 10. (i) The facts are the same as in Example 9, except that the amount charged for the coverage under the arrangement to the employers in a geographic area is initially determined from a rate-setting manual based on the benefit package and then adjusted to reflect the claims experience of the employers in that classification as a whole. The arrangement does not have any geographic area classification for which one of the employers in the classification normally contributes more than 10 percent of the contributions made by all the employers in that classification.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). There is differential pricing under the arrangement because the amounts charged to an employer in one geographic area can be expected to differ from those charged to an employer in another geographic area, and the differences are not merely reflective of current risk or rating factors that are commonly taken into account in manual rates used by insurers for medical benefits.

(iii) Based on the facts described in this Example 10, an employer participating in this arrangement should be able to establish to the satisfaction of the Commissioner that the plan does not maintain experience-rating arrangements with respect to individual employers even though there is differential pricing. Although an employer's cost of coverage for each year is based, in part, on its benefits experience (as well as the benefits experience of the other employers in its geographic area), that does not result in experience-rating arrangements with respect to any individual employer because the employers in each geographic area are a rating group and no employer normally contributes more than 10 percent of the contributions made by all the employers in its rating group. (See paragraph (b)(4)(iii) of this section.)

Example 11. (i) The facts of Arrangement F are the same as those described in Example 10, except that K, an employer in one of Arrangement F's geographic areas, normally contributes more than 10 percent of the contributions made by the employers in that geographic area.

(ii) For the same reasons as described in Example 10, Arrangement F results in differential pricing.

(iii) Arrangement F does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. An employer's cost of coverage for each year is based, in part, on its benefits experience (as well as the benefits experience of the other employers in its geographic area) and the special rule for experience-rating by a rating group does not apply to Arrangement F because employer K normally contributes more than 10 percent of the contributions made by the employers in its rating group. Accordingly, Arrangement F maintains experience-rating arrangements with respect to individual employers.

Example 12. (i) The facts of Arrangement G are the same as those described in Example 10, except for the way that the arrangement classifies the employers. Under Arrangement G, the experience of each employer for the prior year is reviewed and then the employer is assigned to one of three classifications (low cost, intermediate cost, or high cost) based on the ratio of actual claims with respect to that employer to expected claims with respect to that employer. No employer in any classification normally contributes more than 10 percent of the contributions of all employers in that classification.

(ii) For the same reasons as described in Example 10, Arrangement G results in differential pricing.

(iii) Arrangement G does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. The special rule in paragraph (b)(4)(iii) of this section for rating groups can prevent a plan from being treated as maintaining experience-rating arrangements with respect to individual employers if the mere use of a rating group is the only reason a plan would be so treated. Under Arrangement G, however, an employer's cost of coverage for each year is based on the employer's benefits experience in two ways: the employer's benefits experience is part of the benefits experience of a rating group that is otherwise permitted under the special rule of paragraph (b)(4)(iii) of this section, and the employer's benefits experience is considered annually in redetermining the rating group to which the employer is assigned. Accordingly, Arrangement G maintains experience-rating arrangements with respect to individual employers.

Example 13. (i) Arrangement H provides a death benefit equal to a multiple of one, two, or three times compensation as elected by the participating employer for all of its

covered employees. Universal life insurance contracts are purchased on the lives of the covered employees. The face amount of each contract is the amount of the death benefit payable upon the death of the covered employee. Under the arrangement, each employer is charged annually an amount equal to 200 percent of the mortality and expense charges under the contracts for that year covering the lives of the covered employees of that employer. Arrangement H pays the amount charged each employer to the insurance company. Thus, the insurance company receives an amount equal to 200 percent of the mortality and expense charges under the policies. The excess amounts charged and paid to the insurance company increase the policy value of the universal life insurance contracts. When an employer ceases to participate in Arrangement H, the insurance policies are distributed to each of the covered employees of the withdrawing employer.

(ii) Arrangement H exhibits at least three of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets are effectively allocated to specific employers. Second, because the amount of the withdrawal benefit (i.e., the value of the life insurance policies to be distributed) is unknown, the arrangement does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost. Finally, Arrangement H includes nonstandard benefit triggers because amounts can be distributed under the arrangement for a reason other than the illness, personal injury, or death of an employee or family member, or an employee's involuntary separation from employment.

(iii) Arrangement H does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Pursuant to paragraph (b)(1) of this section, the prohibition against maintaining experience-rating arrangements applies under all circumstances, including employer withdrawals. Arrangement H maintains experience-rating arrangements with respect to individual employers because the cost of coverage for a participating employer is based on a proxy for the overall experience of that employer. Under Arrangement H, the contributions of a participating employer are fixed. The benefits or other amounts payable with respect to an employer include the value of the life insurance policies that are distributable to the employees of that employer upon the withdrawal of that employer from the plan. Thus, the cost of coverage for any period of an employer's participation in Arrangement H is the relationship between the fixed contributions for that period and the variable benefits payable under the arrangement. The value of those variable benefits depends on the value of the policies that would be distributed if the employer were to withdraw at the end of the period. (Each year the insurance policies to be distributed to the employees in the event of the employer's withdrawal will increase in value due to the premium amounts paid on the policy in excess of current mortality and expense charges.) For reasons similar to those discussed above in Example 6, the aggregate value of the life insurance policies on the lives of an employer's employees is a proxy for that employer's overall experience. Thus, a participating's employer's cost of coverage for any period is

based on a proxy for the overall experience of that employer. Accordingly, Arrangement H maintains experience-rating arrangements with respect to individual employers.

(iv) The result would be the same if, rather than distributing the policies, Arrangement H distributed cash amounts equal to the cash values of the policies. The result would also be the same if the distribution of policies or cash values is triggered by employees terminating their employment rather than by employers ceasing to participate in the arrangement.

Example 14. (i)(1) The facts of Arrangement J are the same as those described in Example 13 for Arrangement H, except that–

(A) Arrangement J purchases a special term insurance policy on the life of each covered employee with a face amount equal to the death benefit payable upon the death of the covered employee; and

(B) there is no benefit distributable upon an employer's withdrawal.

(2) The special term policy includes a rider that extends the term protection for a period of time beyond the term provided on the policy's face. The length of the extended term is not guaranteed, but is based on the excess of premiums over mortality and expense charges during the period of original term protection, increased by any investment return credited to the policies.

(ii) Arrangement J exhibits two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost because the coverage period is not fixed.

(iii) Arrangement J does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement J maintains experience-rating arrangements with respect to individual employers because the cost of coverage for a participating employer is based on a proxy for the overall experience of that employer. Under Arrangement J, the contributions of a participating employer are fixed. The benefits or other amounts payable with respect to an employer are the one-, two-, or three-times-compensation death benefit for each employee of the employer for the current year, plus the extended term protection coverage for future years. Thus, for any period extending to or beyond the end of the original term of one or more of the policies on the lives of an employer's employees, the employer's cost of coverage is the relationship between the fixed contributions for that period and the variable benefits payable under the arrangement. The value of those variable benefits depends on the aggregate value of the policies insuring the employer's

employees (i.e., the total of the premiums paid on the policies by Arrangement J to the insurance company, reduced by the mortality and expense charges that were needed to provide the original term protection, and increased by any investment return credited to the policies). The aggregate value of the policies insuring an employer's employees is, at any time, a proxy for the employer's overall experience. Thus, a participating employer's cost of coverage for any period described above is based on a proxy for the overall experience of that employer. Accordingly, Arrangement J maintains experience-rating arrangements with respect to individual employers.

Example 15. (i) Arrangement K provides a death benefit to employees of participating employers equal to a specified multiple of compensation. Under the arrangement, a flexible-premium universal life insurance policy is purchased on the life of each covered employee in the amount of that employee's death benefit. Each policy has a face amount equal to the employee's death benefit under the arrangement. Each participating employer is charged annually with the aggregate amount (if any) needed to maintain the policies covering the lives of its employees. However, each employer is permitted to make additional contributions to the arrangement and, upon doing so, the additional contributions are paid to the insurance company and allocated to one or more contracts covering the lives of the employer's employees. In the event that any policy covering the life of an employee would lapse in the absence of new contributions from that employee's employer, and if at the same time there are policies covering the lives of other employees of the employer that have cash values in excess of the amounts needed to prevent their lapse, the employer has the option of reducing its otherwise-required contribution by amounts withdrawn from those other policies.

(ii) Arrangement K exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are allocated to specific employers. Second, because the plan allows an employer to choose to contribute an amount that is different than that contributed by another employer for the same benefit, the amount charged under the plan is not the same for all participating employers (and the differences in the amounts are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided), resulting in differential pricing.

(iii) Arrangement K does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement K maintains experience-rating arrangements with respect to individual employers because the cost of coverage for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under Arrangement K the benefits with respect to an employer for any year are a fixed amount. For purposes of determining the employer's cost of coverage for that year, the Commissioner may treat the employer's contribution under the special rule of paragraph

(b)(4)(ii) of this section (concerning treatment of flexible contribution\ arrangements) as being the minimum contribution amount needed to maintain the universal life policies with respect to that employer for the death benefit coverage for that year. Because the employer has the option to prevent the lapse of one policy by having amounts withdrawn from other policies, that minimum contribution amount will be based in part on the aggregate value of the policies on the lives of that employer's employees. That aggregate value is a proxy for the employer's overall experience. Accordingly, Arrangement K maintains experience-rating arrangements with respect to individual employers.

(g) Effective date--(1) In general. Except as set forth in paragraph (g)(2) of this section, this section applies to contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002.

(2) Compliance information and recordkeeping. Paragraphs (a)(1)(iv), (a)(2), and (e) of this section apply for taxable years of a welfare benefit fund beginning after July 17, 2003.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.419A(f)(6)-1	1545-1795
* * * * *	

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved: July 9, 2003

Pamela F. Olson,
Assistant Secretary of the Treasury.