

§ 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 experience-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 min-

imum 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, to the withdrawing employer 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 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.

(i) 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.

(ii) 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 record-keeping.* 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.

[T.D. 9079, 68 FR 42259, July 17, 2003]

§ 1.420-1 Significant reduction in retiree health coverage during the cost maintenance period.

(a) *In general.* Notwithstanding section 420(c)(3)(A), the minimum cost requirements of section 420(c)(3) are not met if the employer significantly reduces retiree health coverage during the cost maintenance period.

(b) *Significant reduction*—(1) *In general.* An employer significantly reduces retiree health coverage during the cost maintenance period if, for any taxable year beginning on or after January 1, 2002, that is included in the cost maintenance period, either —

(i) The employer-initiated reduction percentage for that taxable year exceeds 10 percent; or

(ii) The sum of the employer-initiated reduction percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.

(2) *Employer-initiated reduction percentage.* The employer-initiated reduction percentage for any taxable year is

the fraction B/A, expressed as a percentage, where:

A = The total number of individuals (retired employees plus their spouses plus their dependents) receiving coverage for applicable health benefits as of the day before the first day of the taxable year.

B = The total number of individuals included in A whose coverage for applicable health benefits ended during the taxable year by reason of employer action.

(3) *Special rules for taxable years beginning before January 1, 2002.* The following rules apply for purposes of computing the amount in paragraph (b)(1)(ii) of this section if any portion of the cost maintenance period precedes the first day of the first taxable year beginning on or after January 1, 2002—

(i) *Aggregation of taxable years.* The portion of the cost maintenance period that precedes the first day of the first taxable year beginning on or after January 1, 2002 (the initial period) is treated as a single taxable year and the employer-initiated reduction percentage for the initial period is computed as set forth in paragraph (b)(2) of this section, except that the words “initial period” apply instead of “taxable year.”

(ii) *Loss of coverage.* If coverage for applicable health benefits for an individual ends by reason of employer action at any time during the initial period, an employer may treat that coverage as not having ended if the employer restores coverage for applicable health benefits to that individual by the end of the initial period.

(4) *Employer action*—(i) *General rule.* For purposes of paragraph (b)(2) of this section, an individual's coverage for applicable health benefits ends during a taxable year by reason of employer action, if on any day within the taxable year, the individual's eligibility for applicable health benefits ends as a result of a plan amendment or any other action of the employer (e.g., the sale of all or part of the employer's business) that, in conjunction with the plan terms, has the effect of ending the individual's eligibility. An employer action is taken into account for this purpose regardless of when the employer action actually occurs (e.g., the date the plan amendment is executed), except that employer actions occurring