

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 Because the employer has the option to prevent the lapse of one policy by having amounts withdrawn from other policies, that minimum contribution amount will be based in part on the aggregate value of the policies on the lives of that employer's employees.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

before the later of December 18, 1999, and the date that is 5 years before the start of the cost maintenance period are disregarded.

(ii) *Special rule.* Notwithstanding paragraph (b)(4)(i) of this section, coverage for an individual will not be treated as having ended by reason of employer action merely because such coverage ends under the terms of the plan if those terms were adopted contemporaneously with the provision under which the individual became eligible for retiree health coverage. This paragraph (b)(4)(ii) does not apply with respect to plan terms adopted contemporaneously with a plan amendment that restores coverage for applicable health benefits before the end of the initial period in accordance with paragraph (b)(3)(ii) of this section.

(iii) *Sale transactions.* If a purchaser provides coverage for retiree health benefits to one or more individuals whose coverage ends by reason of a sale of all or part of the employer's business, the employer may treat the coverage of those individuals as not having ended by reason of employer action. In such a case, for the remainder of the year of the sale and future taxable years of the cost maintenance period —

(A) For purposes of computing the applicable employer cost under section 420(c)(3), those individuals are treated as individuals to whom coverage for applicable health benefits was provided (for as long as the purchaser provides retiree health coverage to them), and any amounts expended by the purchaser of the business to provide for health benefits for those individuals are treated as paid by the employer;

(B) For purposes of determining whether a subsequent termination of coverage is by reason of employer action under this paragraph (b)(4), the purchaser is treated as the employer. However, the special rule in paragraph (b)(4)(ii) of this section applies only to the extent that any terms of the plan maintained by the purchaser that have the effect of ending retiree health coverage for an individual are the same as terms of the plan maintained by the employer that were adopted contemporaneously with the provision under which the individual became eligible

for retiree health coverage under the plan maintained by the employer.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Applicable health benefits.* Applicable health benefits means applicable health benefits as defined in section 420(e)(1)(C).

(2) *Cost maintenance period.* Cost maintenance period means the cost maintenance period as defined in section 420(c)(3)(D).

(3) *Sale.* A sale of all or part of an employer's business means a sale or other transfer in connection with which the employees of a trade or business of the employer become employees of another person. In the case of such a transfer, the term *purchaser* means a transferee of the trade or business.

(d) *Examples.* The following examples illustrate the application of this section:

*Example 1.* (i) Employer W maintains a defined benefit pension plan that includes a 401(h) account and permits qualified transfers that satisfy section 420. The number of individuals receiving coverage for applicable health benefits as of the day before the first day of Year 1 is 100. In Year 1, Employer W makes a qualified transfer under section 420. There is no change in the number of individuals receiving health benefits during Year 1. As of the last day of Year 2, applicable health benefits are provided to 99 individuals, because 2 individuals became eligible for coverage due to retirement and 3 individuals died in Year 2. During Year 3, Employer W amends its health plan to eliminate coverage for 5 individuals, 1 new retiree becomes eligible for coverage and an additional 3 individuals are no longer covered due to their own decision to drop coverage. Thus, as of the last day of Year 3, applicable health benefits are provided to 92 individuals. During Year 4, Employer W amends its health plan to eliminate coverage under its health plan for 8 more individuals, so that as of the last day of Year 4, applicable health benefits are provided to 84 individuals. During Year 5, Employer W amends its health plan to eliminate coverage for 8 more individuals.

(ii) There is no significant reduction in retiree health coverage in either Year 1 or Year 2, because there is no reduction in health coverage as a result of employer action in those years.

(iii) There is no significant reduction in Year 3. The number of individuals whose health coverage ended during Year 3 by reason of employer action (amendment of the plan) is 5. Since the number of individuals

receiving coverage for applicable health benefits as of the last day of Year 2 is 99, the employer-initiated reduction percentage for Year 3 is 5.05 percent (5/99), which is less than the 10 percent annual limit.

(iv) There is no significant reduction in Year 4. The number of individuals whose health coverage ended during Year 4 by reason of employer action is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 3 is 92, the employer-initiated reduction percentage for Year 4 is 8.70 percent (8/92), which is less than the 10 percent annual limit. The sum of the employer-initiated reduction percentages for Year 3 and Year 4 is 13.75 percent, which is less than the 20 percent cumulative limit.

(v) In Year 5, there is a significant reduction under paragraph (b)(1)(ii) of this section. The number of individuals whose health coverage ended during Year 5 by reason of employer action (amendment of the plan) is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 4 is 84, the employer-initiated reduction percentage for Year 5 is 9.52 percent (8/84), which is less than the 10 percent annual limit. However, the sum of the employer-initiated reduction percentages for Year 3, Year 4, and Year 5 is 5.05 percent + 8.70 percent + 9.52 percent = 23.27 percent, which exceeds the 20 percent cumulative limit.

*Example 2.* (i) Employer X, a calendar year taxpayer, maintains a defined benefit pension plan that includes a 401(h) account and permits qualified transfers that satisfy section 420. X also provides lifetime health benefits to employees who retire from Division A as a result of a plant shutdown, no health benefits to employees who retire from Division B, and lifetime health benefits to all employees who retire from Division C. In 2000, X amends its health plan to provide coverage for employees who retire from Division B as a result of a plant shutdown, but only for the 2-year period coinciding with their severance pay. Also in 2000, X amends the health plan to provide that employees who retire from Division A as a result of a plant shutdown receive health coverage only for the 2-year period coinciding with their severance pay. A plant shutdown that affects Division A and Division B employees occurs in 2000. The number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200. In 2002, Employer X makes a qualified transfer under section 420. As of the last day of 2002, applicable health benefits are provided to 170 individuals, because the 2-year period of benefits ends for 10 employees who retired from Division A and 20 employees who retired from Division B as a result of the plant shutdown that occurred in 2000.

(ii) There is no significant reduction in retiree health coverage in 2002. Coverage for the 10 retirees from Division A who lose coverage as a result of the end of the 2-year period is treated as having ended by reason of employer action, because coverage for those Division A retirees ended by reason of a plan amendment made after December 17, 1999. However, the terms of the health plan that limit coverage for employees who retired from Division B as a result of the 2000 plant shutdown (to the 2-year period) were adopted contemporaneously with the provision under which those employees became eligible for retiree coverage under the health plan. Accordingly, under the rule provided in paragraph (b)(4)(ii) of this section, coverage for those 20 retirees from Division B is not treated as having ended by reason of employer action. Thus, the number of individuals whose health benefits ended by reason of employer action in 2002 is 10. Since the number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200, the employer-initiated reduction percentage for 2002 is 5 percent (10/200), which is less than the 10 percent annual limit.

(e) *Regulatory effective date.* This section is applicable to transfers of excess pension assets occurring on or after December 18, 1999.

[T.D. 8948, 66 FR 32900, June 19, 2001]

#### CERTAIN STOCK OPTIONS

#### § 1.421-1 Effective dates and meaning and use of certain terms.

(a) *Option.* (1) For the purpose of section 421, the term “option” includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee