

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

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 an 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.