

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 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

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.