

QUESTIONS AND ANSWERS ABOUT THE FINAL REGULATIONS UNDER SECTION 419A(f)(6)

1. Q. On July 17, 2003, final regulations (Treas. Reg. section 1.419A(f)(6)-1) under section 419A(f)(6) of the Internal Revenue Code (the “Code”) were published in the Federal Register. How do the final regulations affect CJA’s plan?
 - A. As discussed more fully below, CJA welcomes the final regulations. We believe that our plan meets each and every requirement of the final regulations in both form and operation.
2. Q. How do the final regulations differ from the proposed regulations?
 - A. With the exception of two minor and inconsequential changes, discussed below, the final regulations are exactly the same as the proposed regulations. This means that the Internal Revenue Service (the “IRS”) ignored the comments of plan sponsors who took issue with the proposed regulations. [As you know, CJA was the only plan sponsor to testify favorably at the public hearing, and the IRS essentially endorsed CJA’s support for the proposed regulations.]

The final regulations, like the proposed regulations, question whether a plan can effectively be funded with individual, cash-value insurance. In addition, the final regulations, like the proposed regulations, cast doubt on plans that provide termination distributions. Most importantly, the final regulations, like the proposed regulations, endorse the group insurance approach used by CJA. CJA remains the only provider in the market with a qualifying group insurance contract.

3. Q. What do the final regulations say?
 - A. The final regulations set forth a five-pronged test for qualification under section 419A(f)(6) of the Code. The final regulations provide that an employer’s contribution to a welfare benefit fund is exempt from the limitations of sections 419 and 419A, if the welfare benefit fund is part of a “10-or-more employer plan”. In order to qualify as a “10-or-more employer plan” under section 419A(f)(6), a plan must be:
 1. a single plan;
 2. a plan to which more than one employer contributes;
 3. a plan to which no employer normally contributes more than ten percent (10%) of the total contributions to the plan;
 4. a plan that does not maintain an experience-rating arrangement with respect to any individual employer; and
 5. a plan that is maintained pursuant to a written document that requires the plan administrator to maintain records sufficient for the IRS or any participating employer to readily verify that the plan satisfies the requirements of section 419A(f)(6) of the Code and the requirements

of the Proposed Regulations.

4. Q. Do the final regulations impose any other requirements on a plan seeking to qualify under section 419A(f)(6)?

A. The final regulations do two additional things. First, they provide a definition of “experience-rating arrangement with respect to any individual employer”. Section 1.419A(f)(6)-1(b)(1) of the final regulations provides, in part, that:

A plan maintains an experience-rating arrangement with respect to an individual employer . . . 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 . . . is or can be expected to be based, in whole or in part, on the benefits experience or overall experience . . . of that employer or one or more employees of that employer.

In addition, sections 1.419A(f)(6)-1(b)(2) and (3) of the final regulations provide that an experience-rating arrangement can exist either where an employer’s contribution is a function of its claims or investment experience or where an employee’s benefit is based upon the contributions made by his or her employer.

1. where an employer can expect “a reduction in future contributions . . . or a rebate of all or a portion of its contributions, if that employer’s overall experience is positive”, or, likewise, “where an employer can expect its future contributions to be increased if the employer’s overall experience is negative”; and
2. where “benefits for an employer’s employees are (or can be expected to be) increased if that employer’s overall experience is positive or, conversely, where benefits are (or can be expected to be) decreased if that employer’s overall experience is negative”.

The first situation is the generally-accepted definition of “experience-rating”. The second situation is the definition of “experience-rating” crafted by Judge Laro in Booth v. Commissioner, 108 T.C. 524 (1997).

Despite comments from certain plan sponsors that the definition of “experience-rating” should be narrowly defined, the IRS said:

Where a Code section provides an exception from the normal tax requirements, the exception must be narrowly applied and its exclusions interpreted broadly. (Citations) Thus, the exclusion for experience-rating arrangements under the 10 or more plan exception should be interpreted broadly.

5. Q. What else do the final regulations do?

- A. In addition to the five-pronged test and the definition of “experience-rating” set forth above, the final regulations also list five characteristics, the presence of any one of which in a particular plan creates a rebuttable presumption that the plan is not a “10-or-more employer plan” described in section 419A(f)(6).
6. Q. What do you mean by “rebuttable presumption”?
- A. This means that the IRS will treat a plan, having any one of the listed characteristics, as not qualifying under section 419A(f)(6), unless the plan administrator can establish that the plan meets the requirements of section 419A(f)(6) and the five-pronged test set forth in the final regulations, notwithstanding the presence of one or more of the listed characteristics. This is a very heavy burden, because each of the listed characteristics, as set forth by the IRS, is, by design, incompatible with one or more prong of the five-pronged test.
7. Q. What are the listed characteristics?
- A. The listed characteristics are:
1. Assets of the plan are allocated to a specific employer through separate accounting of contributions and expenditures or otherwise.
 2. The amount charged under the plan, in any year, is not the same for all employers participating in the plan, and the difference is not the result of current risk factors commonly taken into account in manual rates by insurers, such as, for example, age, gender and benefit terms.

This second characteristic reflects one of the changes in the final regulations from the proposed regulations. The final regulations limit the risk factors to current risk factors. This means that any plan that charges differential amounts based on issue age, such as whole life or level premium insurance, would exhibit this second characteristic.

3. The plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost.
4. The cost of the benefits is unreasonably high.
5. The plan provides that benefits or other amounts can be paid, distributed, transferred or otherwise provided for a reason other than the death, illness, personal injury or involuntary separation from employment of the employee, such as, for example, the withdrawal of the employer from the plan. This is referred to as “nonstandard benefit triggers”.

This fifth characteristic was also slightly modified in the final regulations. The IRS

added language to the final regulations clarifying that the exercise of a state-mandated conversion right will not constitute a nonstandard benefit trigger, as long as there is no additional value associated with the conversion right.

8. Q. How do the final regulations change existing law?

A. The final regulations do not really change existing law. The IRS does not have the authority to make or change the law. Only Congress can enact legislation. The Code does, however, give the IRS the authority to make such rules and regulations as may be necessary to enforce the laws enacted by Congress. Section 7805(a) of the Code provides, in part, that:

. . . the Secretary shall prescribe all needful rules and regulations for the enforcement of this title . . .

In addition, in National Muffler Dealers Association v. United States, 440 U.S. 472, 477 (1979), the United States Supreme Court said that:

Congress has delegated to the Secretary of the Treasury and his delegate, the Commissioner of Internal Revenue . . . the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code.

9. Q. So, if the final regulations do not change the law, what is all the fuss about?

A. The final regulations reflect the IRS's judgment of what Congress had in mind when section 419A(f)(6) was added to the Code. The final regulations also foreshadow how the IRS intends to enforce section 419A(f)(6) and sets forth the design and operation criteria for a plan seeking to qualify as a "10-or-more employer plan" under section 419A(f)(6).

10. Q. How does CJA's plan stack up against the final regulations?

A. The final regulations support CJA's contention that group insurance is the only way to go.

11. Q. How does CJA's plan meet the definition of "10-or-more employer plan" contained in the final regulations?

A. First, CJA's plan is a "single plan". The final regulations codify the "single plan" requirement, first set forth by Judge Laro in Booth, that, in order to qualify as a "10-or-more employer plan", section 419A(f)(6) requires an arrangement to be a "single plan" and not an aggregation of individual plans. While the final regulations adopt Judge Laro's "single plan" requirement, they do not provide a definition of that term. It must, therefore, be assumed that the IRS also adopted the definition of the term "single plan" provided by Judge Laro in Booth. In other words, in order to qualify as a single plan under section 419A(f)(6), an arrangement must have a single pool

of assets from which the benefits of all participants be paid. CJA's plan satisfies the "single plan" requirement of Booth and the final regulations. The group insurance contract used by CJA is the single asset from which the death benefits of all participants will be paid. Plans funded with individual, cash-value insurance cannot satisfy this requirement. Each policy constitutes a separate plan, because the benefit of any participant will be paid exclusively from the policy issued on his life.

12. Q. What about the other requirements of the five-pronged test?
- A. The second and third requirements are simple mathematical calculations. CJA's plan has more than two hundred participating employers, clearly well in excess of the requirement that more than one employer participate in the plan. In addition, no employer normally contributes more than ten percent (10%) of all contributions to the plan, whether in any given year or over the life of the plan. CJA's plan does not maintain an experience-rating arrangement with respect to any individual employer. Finally, the burden has always been on a plan administrator to establish that its plan satisfies the requirements of section 419A(f)(6), and CJA's plan documents require the plan administrator to take any and all action, and to keep such books and records, as are required to maintain the plan's status as a "10-or-more employer plan" under section 419A(f)(6).
13. Q. Why is it that CJA's plan does not maintain an experience-rating arrangement with respect to any individual employer?
- A. CJA's plan does not maintain an experience-rating arrangement with respect to any individual employer participating in the plan, because there is no period for which an employer's contribution is based upon its overall experience. An employer's contribution to the plan is based upon rates established by the insurer for the product used by the plan and reflect the current risk undertaken by the insurance company. While the rate for a particular employee may vary depending upon the age, gender or health of that employee, the rates are uniformly applied to all employers participating in the plan. This means that the contributions of similarly-situated employers will always be the same and will not vary depending upon the individual loss, investment or contribution history of an employer. In fact, no employer participating in the plan will have an individual investment experience. Furthermore, the benefits paid upon the death of a participant are not a function of the assets of the participant's employer. First, there is a single pool of assets belonging to the plan. Assets are not segregated by employer. Second, the plan's death benefits are a function of a formula and are not subject to adjustment by the plan administrator. This is not true of plans funded with individual, cash-value insurance. In those plans, an employer's required contribution is the amount needed to keep its policies in force. That amount is a function of past contributions and investment experience, which will differ from employer to employer.
14. Q. Does CJA's plan have any of the listed characteristics?

A. No. CJA's plan:

1. does not separately allocate the plan's assets among the participating employers. CJA's plan has a single asset - the group insurance contract - from which the benefits of all participants will be paid and in which no employer has any right, title or interest.
2. requires the same contribution for similarly-situated employers. The only difference in employer contributions is a function of "current risk or rating factors that are commonly taken into account in manual rates used by insurers".
3. provides a fixed benefit for a fixed period for a fixed cost. The fixed benefit is based upon the employer's formula and cannot be adjusted by the plan administrator to match the employer's overall experience. The fixed period is one year, because the product is annual renewable term. The fixed cost is the premium established by the insurance company and is applied uniformly to all participants.
4. does not charge an unreasonably high amount for the benefit. The cost is actuarially determined by the insurance company and is the same cost charged to non-plan-participant purchasers of the company's product. In addition, an employer's contribution is comprised of two components. The first is the cost of current term insurance protection. The second is the current cost of the plan's post-retirement death benefit funded on a level basis over the working life of the participant. The first element was expressly allowed by Judge Laro in Neonatology Associates, P.A., et al. v. Commissioner, 115 T.C. No. 5 (2000), recently affirmed by the U.S. Court of Appeals for the Third Circuit. The second element is expressly authorized by the Code in section 419A(c)(2) and has long been accepted by the IRS in various revenue rulings.
5. provides benefits only in the event of the death of an employee. No other event, such as the employer's withdrawal from the plan, triggers a payment, distribution or transfer of any amount to, or for the benefit of, the employee.

15. Q. Do plans funded with individual, cash-value insurance have any of these characteristics?

A. Yes. A plan funded with individual, cash-value insurance:

1. by design, separately allocates assets by employer. An employer's obligation to make a current contribution to a plan funded with individual, cash-value insurance depends upon whether premiums are required to keep the policies on its employees in force. Also, an

employer that contributes more than the cost of insurance in any particular year will want assurance that its excess contributions will be credited to its policies and not to the group as a whole.

2. does not require the same contribution for similarly-situated employers. An employer's contribution is a function of the performance of the individual policies on its employees.
3. does not provide a fixed benefit for a fixed period of time for a fixed cost. An employee's benefit will be maintained only as long as the policy on his life has sufficient value to keep from lapsing. This period will vary from employee to employee and policy to policy.
4. does charge an unreasonably high amount for the benefit since the employer's contribution is not limited to the cost of insurance.
5. does provide a benefit in a circumstance other than the death of the employee. These plans use individual, cash-value insurance in order to have a tangible asset to distribute to an employee upon his employer's withdrawal from the plan.

16. Q. Sponsors of plans funded with cash-value insurance are saying that the final regulations do not prohibit such insurance. Are they right?

A. Yes and No. There is language in the preamble to the final regulations that supports their argument. This language says:

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 insurance. (emphasis added)

However, this language does not mean that sponsors of plans funded with cash-value insurance are home free. First, this language simply means that funding with cash-value insurance does not *per se* equate to experience-rating. A plan funded with cash-value insurance still must satisfy the other requirements of section 419A(f)(6) and the final regulations, including the single plan requirement. As discussed above, because a plan funded with individual, cash-value insurance essentially segregates a participant's death benefit from the experience of any other participant in the plan, a plan funded with individual, cash-value insurance is not a single plan, but an aggregation of individual plans. Second and most importantly, the preamble to the final regulations also state that, if that portion of the premium paid by an employer in excess of the cost of insurance inures to the benefit of that employer, which is the only reason an employer would pay excess premiums, then the arrangement is

experience-rated.

. . . 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.

17. Q. Some plan sponsors are also saying that the final regulations do not prohibit termination distributions. Are they right?

A. Again, the answer is yes and no. There is language in the final regulations that seems to sanction termination distributions:

A number of commentators expressed concern that this fifth characteristic (i.e. nonstandard benefit trigger) effectively prohibits a termination of a welfare benefit arrangement or otherwise redefines what is a welfare benefit arrangement. This concern reflects a misreading of the regulations, as this fifth characteristic does not prohibit the payment of benefits upon termination of the arrangement or withdrawal of an employer from the arrangement . . .

However, while the preamble seems to permit distributions upon an employer's withdrawal from a plan, it cautions against a form of distribution, which constitutes experience-rating.

Instead the characteristic reflects the inherent difficulty an insurer would have in determining an actuarially appropriate price for providing fixed benefits on the occasion of these nonstandard benefit triggers and the associated likelihood that the amount of the benefits payable on such an occasion is being determined based on the overall experience of the employee or employer. The fact that some commentators have suggested that an employer be able to "spin-off" the employer's "share" of a fund is further indication that many plans that purport to fit with the section 419A(f)(6) exception are engaging in prohibited experience rating.

The distribution of a policy, or the cash value from that policy, will constitute an individual experience-rating arrangement.

18. Q. When are the final regulations effective?

A. The final regulations apply to an employer's contributions paid or incurred in taxable years of the employer beginning on or after July 11, 2002. In addition, they apply for taxable years of a welfare benefit fund beginning after July 17, 2003, the date of publication in the Federal Register.

19. Q. Do the final regulations signal the end of section 419A(f)(6)?

- A. **NO!!!!!!!!!!!!!!!!!!!!!!!!!!!!!!** The final regulations create a safer and more certain environment for section 419A(f)(6) plans than existed prior to July 11, 2002. As stated above, the IRS cannot make law. It can only interpret the provisions of the Code as enacted by Congress. Congress intentionally included section 419A(f)(6) when it added sections 419 and 419A to the Code, and the IRS cannot delete or nullify that provision by regulation. With the issuance of the final regulations, the IRS has finally provided guidance as to the requirements for qualification under section 419A(f)(6). It is only those promoters, whose plans do not satisfy the requirements of the final regulations, who will say that the final regulations signal the death knell of section 419A(f)(6). CJA's plan is in full compliance with the final regulations, and, as a result, CJA welcomes them.