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Proposed IRS Regulation on ACA \$500,000 Deduction Limit

The Patient Protection and Affordable Care Act ("ACA") restricts the deductibility of compensation paid by certain health insurers to an individual to \$500,000 per year under Internal Revenue Code ("Code") section 162(m)(6). Previously, the IRS issued Notice 2011-2 (the "Notice") which provided initial guidance and transition relief on the deduction limitations in Code section 162(m)(6). The IRS recently issued detailed proposed regulations that generally incorporate the terms of the Notice along with certain additions and changes based in part on comments received in response to the Notice. 78 Fed. Reg. 19950 (Apr. 2, 2013). Comments may be submitted until July 1.

The proposed regulations can be relied upon until the issuance of final regulations. The Treasury Department and IRS anticipate that final regulations will be issued before covered health insurance providers must file an income tax return reflecting the deduction limits of Code section 162(m)(6).

We note that these new compensation deduction limits on health insurers are much broader than the longstanding \$1 million deduction limit that applies to the "Top 5" employees of public companies. They follow similar, temporary deduction limitations on compensation paid by financial institutions that participated in the Troubled Asset Relief Program ("TARP"), as well as provisions in Senate-passed (but never enacted) legislation in 2007 that generally would have made similar changes to Code section 162(m) generally. In the current economic and political environment, Congress may well consider similar proposals that would apply to a much broader group of companies (e.g., all public companies) as potential revenue raisers in future budget and tax reform legislation. Therefore, even companies that are not subject to the new deduction limits may nevertheless be interested in the new guidance.

We describe below some of the key issues addressed in the proposed regulation. As in the Notice, the IRS has helpfully limited the coverage of the deduction limitation to organizations with a focus on providing health insurance.

"Covered Health Insurance Providers"

In general, the \$500,000 deduction limitation applies to compensation for services provided during any year after 2009 in which a company is a "covered health insurance provider" or "CHIP". For years after 2012, a company will be a CHIP only if at least 25 percent of the premiums it receives from providing health insurance coverage are from providing "minimum essential coverage," as defined in the ACA.

“Aggregated Group” Covered

The statute provides that all entities that are treated as members of the same controlled group under the qualified plan rules (Code section 414) will be treated as one employer for this purpose (with exceptions for brother-sister corporations and combined group arrangements). The proposed regulation clarifies that entities that are not health insurance issuers will be included in the aggregated group of the CHIP, and therefore are subject to the \$500,000 limit.

Captive Insurance Companies

The Notice had requested comments on whether the regulation should include an exception to the deduction limitation for captive insurers. The preamble to the proposed regulation states that a captive insurance company is treated as a CHIP if it otherwise meets the requirements of a CHIP. Nevertheless, the de minimis exception (described below) should help many corporate controlled groups with captive insurers avoid the reach of the \$500,000 deduction limit.

IRS Relief on Covered Health Insurance Providers

The proposed regulation follows the Notice by providing that the deduction limit will only apply to a company in a post-2012 year if it is a CHIP for that year. The proposed regulation also provides some additional relief and clarifications on who is covered by the ACA deduction limit:

- *Employers with Self Insured Plans and VEBAs* – The proposed regulation offers helpful relief by providing that an employer (or VEBA) with a "self-insured medical reimbursement plan" will not be considered a CHIP. For these purposes, a "self-insured medical reimbursement plan" means a separate written plan for the benefit of employees or former employees that provides reimbursement of medical expenses under Code section 105(b) without reimbursement under an insurance policy or prepaid healthcare plan.
- *De Minimis Exemption* – The proposed regulation adopts a de minimis exception that is a substantially similar to the one described in the Notice. Generally, a company will not be treated as a CHIP for a year if its sales from the relevant category of insurance (pre-2013 – health insurance; post-2012 – minimum essential coverage) are less than 2% of the company's aggregated group gross revenues for the year. This provision should remove insurance companies with small legacy health business, as well as captive insurers, from the reach of the \$500,000 limit.

The proposed regulation extends the de minimis exception to allow companies that are not treated as a CHIP solely due to the de minimis exception in a taxable year to continue to fall under the exception in the immediately following taxable year. According to the preamble, this change is intended to accommodate any unexpected changes in revenue sources or other events that could affect application of the exception to an employer, and provide an affected employer with time to adjust its compensation programs.

- *Reinsurance Premiums* – The proposed regulation follows the Notice by generally providing that, for purposes of determining whether an entity is a covered health insurance provider, premiums received under an indemnity reinsurance contract will not be treated as premiums received for providing health insurance. However, for this relief to apply under the proposed rules, the reinsurance contract must provide that the

reinsuring company agrees to indemnify the health insurance issuer for all or part of the risk of loss under the specified policies, and the health insurer must retain its liability, and contractual relationship, with the individual insured.

- *IRS Relief on Covered Individuals* – The \$500,000 deduction limit applies to the compensation of all individuals who provide services to a CHIP, not just the company's executives. The proposed regulation adopts the exception in the Notice that removes compensation paid to certain independent contractors from the scope of the limit. Generally, it provides that individuals will not be covered if their compensation arrangements would be exempt from Code section 409A because they are providing significant services to two or more unrelated entities.

The Treasury Department and IRS did not create a specific exception for services performed pursuant to contracts with a partnership or corporation. The preamble states that a partnership or corporation generally would not be a covered individual, but indicates that Treasury and IRS are concerned that including such an exception could encourage employees and independent contractors to form small or single-member personal service corporations or similar entities in an attempt to avoid the deduction limits. The Treasury Department and IRS request comments on how to “address this potential abuse.”

- *Corporate Transactions* – The proposed regulation offers limited relief in the case of a corporate transaction resulting in a change of the composition of the aggregated group. It provides that if an entity that is not otherwise a CHIP becomes a CHIP solely as a result of the corporate transaction, the entity will not be treated as a CHIP for the tax year in which the transaction occurred. The entity will, however, be subject to the deduction limit in subsequent tax years.

The corporate transaction relief is not available to any entity that was a CHIP prior to the transaction. Additionally, the transition relief does not apply to compensation received by applicable individuals of a CHIP that is not covered by the transition relief from other members in the aggregated group that are otherwise eligible for the transition relief.

Deduction Limit

Generally, the \$500,000 deduction limit applies to aggregate “applicable individual remuneration” and “deferred deduction remuneration” attributable to services performed by any individual (not just the CHIP’s executives) for a CHIP for a disqualified year. Unlike the general Code section 162(m) deduction limits for public companies, there are no exceptions to the ACA deduction limit for performance-based compensation, commission payments, or payments made under existing binding contracts. In addition, the ACA deduction limit continues to apply to payments made to individuals after they terminate employment. Thus, the scope of the ACA deduction limit is much broader than the limitation that applies to the top four or five executives at a public company under Code section 162(m).

The proposed regulation contains detailed rules on how to determine and track the amount of the compensation attributable to services performed in a particular year. “Applicable individual remuneration” is defined generally as the aggregate amount that is allowable as a deduction for an individual for a disqualified year for remuneration for services performed by that individual (whether or not during that year), except for deferred deduction remuneration. Deferred deduction remuneration is defined generally as remuneration that would be applicable individual remuneration for services an individual performs during a disqualified year, but for the fact it is not deductible until a later year (e.g., nonqualified deferred compensation). For any taxable year, the deduction limit is first applied to any

of the applicable individual remuneration for services performed in the year, and any remaining amount of the deduction limit can be applied to the deferred deduction remuneration attributable to services performed in that year. Such deferred deduction remuneration within the ACA deduction limit is deducted when the related deduction is otherwise allowed (e.g., when the deferred compensation is included in income by the individual). Any deferred deduction remuneration in excess of the remaining deduction limit is not deductible in any taxable year (even if the company is not a CHIP when the amount becomes otherwise deductible).

Attribution Rules

The proposed regulation includes detailed and complex rules on how to attribute remuneration to the appropriate tax year. In general, remuneration is attributable to services performed by an individual in the CHIP's tax year in which the individual obtains a legally binding right to the remuneration, unless it is attributable to a different tax year under another provision in the proposed regulation. It also provides separate attribution rules for the following categories of compensation:

- account balance plans,
- nonaccount balance plans,
- equity-based remuneration (stock options and SARs; restricted stock; RSUs; and partnership or other equity interests),
- involuntary separation pay,
- reimbursements, and
- split-dollar life insurance.

For certain categories of compensation, the proposed regulation provides alternative attribution methods. In the case of certain types of compensation that are subject to a substantial risk of forfeiture (applying the definition under Code section 409A), the amounts are reattributed on a pro rata basis over the period that the compensation was subject to a substantial risk of forfeiture (i.e., the vesting period). These attribution rules are extremely complicated and may force affected companies to maintain extensive recordkeeping systems to properly calculate and track deductible amounts.

Pre - 2013 Deferred Compensation

The proposed regulation provides welcome relief to certain companies by adopting the transition rule provided in the Notice for deferred deduction remuneration attributable to services performed before 2013. Specifically, it provides that the deduction limit generally applies only to deferred deduction remuneration attributable to services performed in the period 2010 – 2012 if the company is a pre-2013 CHIP for the year in which the remuneration is attributable, and a post 2012-CHIP for the year the deferred deduction remuneration is otherwise deductible.