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Final Regulations Issued on ACA $500,000 Deduction Limit for Health Insurers

The Patient Protection and Affordable Care Act ("ACA") restricts the deductibility of compensation paid by certain health insurance issuers to an individual to $500,000 per year. The IRS recently issued final regulations regarding these rules under Code section 162(m)(6). Previously, the IRS issued proposed regulations and Notice 2011-02, each of which provided initial guidance and transition relief regarding the deduction limitation in Code section 162(m)(6). The final regulations largely adopt, with some modification, the provisions set forth in the proposed regulations. The final regulations apply to taxable years beginning on or after September 23, 2014.

Overview and Possible Broader Implications

As the summary below makes clear, the Code section 162(m)(6) compensation deduction limitation on health insurance issuers is much broader than the longstanding $1 million deduction limitation that applies to the "Top 5" employees of public companies. 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 legislation. For example, in the tax reform discussion draft released earlier this year, House Committee on Ways and Means Chairman Dave Camp (R-Mich.) proposed to, among other things, expand the reach of the $1 million deduction limitation for public companies to commissions and performance-based compensation. Given the potential by Congress to expand deduction limitations beyond their current scope, even companies that are not subject to the new deduction limits may be interested in the new guidance.

In general, Code section 162(m)(6) limits to $500,000 the allowable deduction for remuneration attributable to services performed by an "applicable individual" for a "covered health insurance provider" ("CHIP") in a taxable year beginning after 2012 that, but for Code section 162(m)(6), is otherwise deductible. Remuneration attributable to services performed by an applicable individual for a CHIP in a taxable year beginning after 2009 and before 2013 that becomes otherwise deductible in a taxable year beginning after 2012 is also subject to the $500,000 limitation.

A high-level discussion of certain issues related to CHIPs, applicable individuals, remuneration subject to the Code section 162(m)(6) deduction limit, and attribution rules follows.

"Covered Health Insurance Provider"

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." As in the proposed regulations, the final regulations provide that: (i) for taxable years after 2012, a company will be a CHIP if not less than 25 percent of the premiums it receives from providing health insurance coverage are from providing "minimum essential coverage," as defined in the ACA ("Post-2012 CHIP"); and (ii) for taxable years beginning after 2009 and before 2013, a health insurance issuer is a CHIP for a taxable year if it receives any premiums from providing health insurance coverage during the taxable year ("Pre-2013 CHIP").

Entities in an "Aggregated Group" Are Generally CHIPs. 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 final regulations, like the proposed regulations, clarify that entities that are not health insurance issuers and that do not provide health insurance coverage will be included in the aggregated group of the CHIP and therefore are generally subject to the $500,000 limit.

Treatment of Captive Insurance Companies. The final regulations confirm that a captive insurance company is a CHIP if it is a health insurance issuer that is otherwise described in Code section 162(m)(6)(C). Employers insuring the health risks of their employees through captive insurance companies often do so by purchasing health insurance through an unrelated insurance company, which in turn reinsures the health risks through the employer's captive insurance company under an indemnity reinsurance arrangement (as detailed in certain ERISA individual prohibited transaction exemptions). Because the amounts received by a captive insurance company under this type of arrangement are solely payments for providing indemnity reinsurance (which, as discussed below, are generally not considered premiums for purposes of Code section 162(m)(6)), those payments are not treated as premiums for purposes of Code section 162(m)(6). Thus, in these types of arrangements, the captive insurance company will not be a CHIP. With respect to captive insurance companies that receive premiums other than through indemnity reinsurance arrangements, the de minimis exception, described below, will hopefully help them avoid the reach of the $500,000 deduction limit.

Relief for CHIPs. The final regulations provide some relief and clarifications on the entities that are subject to the deduction limitation.

- **Continued Relief for Self-Insurers**. As with the proposed regulations, the final regulations provide that an employer is not a CHIP solely because it maintains a self-insured medical reimbursement plan. Such a self-insured medical reimbursement plan may be a VEBA.

- **De Minimis Exception**. The final regulations retain the de minimis exception set forth in the proposed regulations with certain clarifications. An entity that would otherwise be a CHIP for any taxable year beginning after 2012 is not a CHIP for that taxable year if the premiums received by that entity and all other members of its aggregated group from providing health insurance coverage that is minimum essential coverage are less than two percent of the gross revenue of that entity and all other members of its aggregated group for that taxable year. For taxable years beginning after 2009 and before 2013, an entity that would otherwise be a CHIP is not a CHIP for that taxable year if the premiums received by that entity and all other members of its aggregated group from providing health insurance coverage are less than two percent of the gross revenue of that entity and all other members of its aggregated group for that taxable year.

Despite receiving comments urging adoption of an increased de minimis threshold percentage, the IRS retained the two-percent threshold in the final regulations, concluding that the two-percent threshold strikes the appropriate balance between exempting entities that receive health insurance premiums that are insignificant in relation to their overall activities and ensuring that entities that sell a significant amount of health insurance are not exempted from the deduction limitation.

In addition, the final regulations retain the relief in the proposed regulations that provides that a company that is not treated as a CHIP solely due to the de minimis exception in one year will continue to be exempt from CHIP status under the de minimis exception in the next year, even if it no longer satisfies the de minimis exception in practice. The intent behind this relief is to accommodate any unexpected changes in revenue sources or other events that could affect an entity's ability to satisfy the de minimis exception and to provide such an entity with time to adjust its compensation programs following loss of the exception.

- **Indemnity Reinsurance**. As with the proposed regulations, the final regulations generally provide that, for purposes of determining whether an entity is a CHIP, premiums received under an indemnity reinsurance contract will not be treated as premiums received for providing health insurance. However, for this relief to apply, 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 subject policies, and the health insurance issuer must retain its liability and contractual relationship with the individual insured.

- **Stop-Loss Coverage**. The Departments of the Treasury, Labor, and Health and Human Services are in the process of considering whether, and to what extent, stop-loss coverage constitutes health insurance. To this end, the final regulations provide that premiums from stop-loss coverage will not be considered premiums from providing health insurance coverage for purposes of Code section 162(m)(6) until such time, and to the extent, that the Departments determine whether, and, if so, under what circumstances, stop-loss coverage constitutes health insurance.

- **Transition Relief for Corporate Transactions**. A corporation or other entity may become a CHIP as a result of certain corporate transactions resulting in a change in the composition of an aggregated group. The final regulations provide that, if an entity becomes a CHIP solely as a result of a corporate transaction, the entity generally will not be a CHIP for the taxable year in which the transaction occurs. (The entity generally will be a CHIP in later taxable years, so long as a member of the aggregated group going forward remains a CHIP.) The transition relief is not available to an entity that was a CHIP immediately prior to a corporate transaction.

  This relief does not apply where an entity that is eligible for the transition relief pays remuneration to a person who is an applicable individual with respect to a health insurance issuer or a non-health insurance issuer who was a CHIP prior to the corporate transaction. For example, if a controlled group of corporations that are not CHIPs acquires a health insurance issuer and its non-health insurance issuer subsidiary, both of which are CHIPs prior to the occurrence of the corporate transaction, the deduction limitation will apply to all remuneration paid to the applicable individuals of the health insurance issuer and its non-health insurance issuer subsidiary, even if the remuneration is paid by a member of the acquiring controlled group that is otherwise eligible for the transition relief during the year of the acquisition.

"Applicable Individuals"

The deduction limitation applies to remuneration paid to applicable individuals. For this purpose, the term "applicable individual" means any individual:

(i) who is an officer, director, or employee with respect to a CHIP in such taxable year; or

(ii) who provides services for, or on behalf of, the CHIP during the taxable year.

The final regulations provide that the term "applicable individual" does not include an independent contractor if he/she satisfies certain requirements. Very generally, an independent contractor will not be an applicable individual if his/her compensation arrangement would be exempt from Code section 409A because he/she is providing significant services to two or more unrelated entities.

A corporation, partnership, or other entity that is not a natural person generally would not be an "applicable individual." However, due to concerns regarding the potential for abuse, the IRS has reserved the right to issue guidance in the future identifying situations in which services performed by an entity will be treated as services performed by an individual for purposes of Code section 162(m)(6).

Remuneration Subject to $500,000 Deduction Limitation

The deduction limitation applies to both applicable individual remuneration and deferred deduction remuneration.

"Applicable individual remuneration" is defined generally as the aggregate amount that is allowable as a deduction (determined without regard to Code section 162(m)) with respect to an applicable individual for a taxable year for remuneration for services performed by that individual (whether or not during the taxable year), except that it does not include any amount that is deferred deduction remuneration.

"Deferred deduction remuneration" is remuneration that would be applicable individual remuneration for services that an applicable individual performs during a taxable year but for the fact that it is not deductible until a later taxable year (*e.g.*, nonqualified deferred compensation).

The deduction limitation for a year applies to the aggregate applicable individual remuneration and deferred deduction remuneration attributable to services performed by an applicable individual for a CHIP in a taxable year. For any taxable year, the deduction limit is first applied to the applicable individual remuneration for services performed in that 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 $500,000 deduction limit is deducted when the related deduction is otherwise allowed (*e.g.*, when the deferred compensation is included in income by the individual). Anything in excess of $500,000 for a taxable year is not allowable as a deduction in any taxable year.

Attribution Rules

The final regulations include detailed and complex rules on how to attribute remuneration to the appropriate taxable year; an in-depth discussion of these rules is beyond the scope of this summary. The rules in the final regulations are similar to those in the proposed regulations. However, the final regulations contain additional detailed examples.

Very generally, remuneration is attributable to services performed by an individual in the CHIP's taxable year in which the individual obtains a legally binding right to the remuneration, unless it is attributable to a different taxable year under another provision in the final regulations. In addition, remuneration is not attributable to a taxable year during which the individual is not a service provider.

The final regulations provide separate attribution rules for the following categories of compensation:

- account balance plans;
- nonaccount balance plans;
- equity-based compensation (*e.g.*, options, restricted stock, RSUs);
- involuntary separation pay;
- reimbursements; and
- split-dollar life insurance.

For certain categories of compensation, the final regulations provide 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 attributed on a pro rata basis over the period that the compensation was subject to a substantial risk of forfeiture (i.e., the vesting period). The 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 final regulations retain transition relief included in the proposed regulations that provides that the Code section 162(m)(6) deduction limitation applies to deferred deduction remuneration attributable to services performed in taxable years beginning after 2009 and before 2013 only if the CHIP is a "Pre-2013 CHIP" for the taxable year to which the deferred deduction remuneration is attributable and a "Post-2012 CHIP" for the taxable year in which the deferred deduction remuneration is otherwise deductible.