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TOPIC: Final Regulations on $500,000 Deduction Limitation for Compensation Paid by Health Insurance Providers

CITATION: T.D. 9694, 2014FED ¶47,051; IRC Section 162(m)(6).

SUMMARY: The IRS has issued final regulations implementing Code Section 162(m)(6)—the Affordable Care Act $500,000 limit on the deductibility of compensation paid to executives by health insurance providers. There are no exceptions for the payment of performance-based compensation and amounts are counted in the year services are performed, without regard to timing of payment. Even if a company is not a health insurance issuer, final regulations provide that it may be subject to IRC Section 162(m)(6) under the aggregated group rules or as a result of a corporate transaction.

DISCUSSION: IRC §162(m)(6) was included in the Affordable Care Act to make non-deductible "Remuneration" of "Applicable Individuals" in excess of $500,000 per year for Covered Health Insurance Providers ("CHIPs"). The IRS has now issued final regulations implementing this section. The final regulations became effective September 23, 2014.

What is a "CHIP?"

A company that issues health insurance is considered a CHIP if 25% or more of the health insurance premiums it receives are from "minimum essential coverage" (generally, coverage that is sponsored by an employer, governmental coverage or coverage offered in any state's individual market). This includes partnerships and privately held companies, in addition to publicly traded companies. In an "aggregate group" of companies (companies under common control)—if one entity is a CHIP, then *all* entities in the group may be considered a CHIP. The final regulations do provide a *de minimis* exception for aggregate groups in which premiums for "minimum essential coverage" constitute less than 2% of gross revenue. The final regulations also provide that employers that self-insure medical coverage will not, *solely* for that reason, become CHIPs.

Who is an "Applicable Individual?"

Applicable Individuals include employees, officers and directors of a CHIP, as well as people who provide services to, or on behalf of a CHIP. The IRS noted that, in the future, it might provide additional guidance to prevent executives from circumventing the rules by setting up separate entities to sell services to CHIPs.

There are exceptions. Independent contractors who are exempt from Section 409A (generally, those providing services to multiple, unrelated clients) are also exempt from these new CHIP regulations. Thus, insurance brokers would generally be exempt to the extent that no more than 70% of their revenue was coming from a single insurance company. Because of the broad definition of CHIP, officers, directors and employees of affiliated companies will also be subject to the compensation limits.

What is "Remuneration?"

The limits in §162(m)(6) apply to all compensation of an Applicable Individual, including equity awards, commissions, and other performance-based compensation—including deferred compensation. The $500,000 deduction limit applies to the year in which the compensation is earned; not the year in which it would be deductible. Because of this, the regulations include very complicated rules for determining *when* various types of remuneration (e.g., stock options, restricted stock units, various types of deferred compensation plans, severance pay) are earned for purposes of §162(m)(6). The $500,000 limit applies to remuneration earned in 2010 or later, which becomes deductible in 2013 or later.

The $500,000 deduction limit is applied first to salary earned during a particular year; then to deferred compensation in the first year it becomes deductible. For example, assume a CHIP employee was paid salary of $350,000 in 2014 and also earned a $250,000 bonus which is vested in 2014 but payable in 2020 under a non-qualified deferred compensation arrangement. In 2014, the CHIP could deduct the $350,000—leaving $150,000 in the deductibility cap. In 2020—when the $250,000 bonus is paid and first becomes deductible—the company can deduct only the $150,000 remaining under the cap. The $100,000 excess cannot be deducted in 2020, or any later year even if other compensation earned in the year of payment is below the $500,000 cap.

Complex rules apply to spread the attribution of deferred compensation which is subject to a substantial risk of forfeiture over the applicable vesting period. Thus, it will be necessary for organizations subject to these rules to separately track the deductibility of deferred compensation balances on a class year basis based on the employee's earnings during the years between deferral and payment.

RELEVANCE: It is important to be alert to the issues raised by IRC §162(m)(6) and the implementing regulations when dealing with entities affiliated with a medical insurance issuer. Related entities may be subject to the IRC §162(m)(6) limits even though the entity itself is not an insurance company. For example, parent corporation employees could run afoul of deductibility limits if one of their subsidiaries is a medical insurer.

Subject companies must be aware of and follow the rules for allocating remuneration to the years in which it was earned to determine whether the $500,000 cap will limit deductibility of compensation paid in later years. The new rules will require separate complex tracking of deferred compensation balances which may provide an opportunity for consultants familiar with these rules.

Note: Insurance brokers receiving more than 70% of their revenue from a single health insurance provider may be subject to the limitations.

***WRNewswire* #14.10.24 was written by Marla Aspinwall of Loeb & Loeb, LLP.**

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