

# Clients & Friends Memo

## Treasury and the IRS Propose Regulations on \$500,000 Compensation Deduction Limit for Health Insurers

May 8, 2013

### I. Introduction

On April 2, 2013, the Treasury Department and the IRS issued [proposed regulations](#)<sup>1</sup> under section 162(m)(6) of the Internal Revenue Code,<sup>2</sup> which generally imposes an annual \$500,000 limitation on the amount that certain health insurers and their affiliates (“**Covered Health Insurance Providers**” or “**CHIPs**”) may deduct for compensation paid to an employee.<sup>3</sup> This limitation is contained within section 162(m) of the Code, which historically has governed the deductibility of compensation paid by public companies to certain of their senior executive officers. However, the \$500,000 limitation in subpart (6) of section 162(m) is much broader in scope and applies to all CHIPs, whether public or private, and to all of a CHIP’s current or former officers, directors, employees and related service providers.

The Proposed Regulations provide:

- Additional guidance on qualification as a CHIP, including exceptions for *de minimis* premiums, self-insured plans, reinsurance plans, and other similar arrangements.
- Further guidance excepting compensation paid to independent contractors, corporations and partnerships from the \$500,000 deduction limitation.
- Timing rules regarding when compensation is deemed to be paid for purposes of applying the \$500,000 compensation limitation within a taxable year.<sup>4</sup>

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<sup>1</sup> 78 Fed. Reg. 19950 (Apr. 2, 2013).

<sup>2</sup> Internal Revenue Code of 1986, as amended (the “**Code**”).

<sup>3</sup> This provision was added to the Code by the Patient Protection and Affordable Care Act of 2010 (the “**Affordable Care Act**”).

<sup>4</sup> The Proposed Regulations build on guidance issued by the IRS in 2011. See *generally* I.R.S. Notice 2011-2, 2011-1 C.B. 260.

This memorandum summarizes the provisions of the Proposed Regulations and highlights those portions of particular importance to health insurers, members of corporate groups affiliated with a health insurer, and their respective executives.

## II. Overview of the Deduction Limitation

Section 162(m)(6) of the Code imposes a \$500,000 limit on a CHIP's<sup>5</sup> deduction for the combined "applicable individual" and "deferred deduction"<sup>6</sup> compensation paid to certain employees<sup>7</sup> for taxable years after December 31, 2012. "Deferred deduction" compensation includes compensation that relates to services performed in any taxable year beginning after December 31, 2009 and before January 1, 2013.

## III. CHIP Status and Exceptions

The Proposed Regulations indicate that the determination as to whether a person or entity is a CHIP is made with reference to an individual taxable year; a taxpayer may be a CHIP in one taxable year but not the next. The Proposed Regulations also provide that all entities related to a CHIP are aggregated with the CHIP and treated as a single employer for purposes of applying the deduction limitation (an "**Aggregated Group**").<sup>8</sup>

The Proposed Regulations establish three exceptions to CHIP status: (1) the *de minimis* premiums exception; (2) the reinsurance exception; and (3) the self-insured plan exception.

The *de minimis* exception provides that no member of an Aggregated Group will be a CHIP if the health insurance premiums received by such group are less than 2% of the aggregate gross revenue of all members of the Aggregated Group, so long as a member does not qualify for CHIP status independently.

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- <sup>5</sup> Generally, a CHIP is any taxpayer that issues health insurance and receives 25% or more of its gross health insurance premiums by providing "minimum essential coverage" (as that term is defined by the Affordable Care Act) or is related to any other such taxpayer.
- <sup>6</sup> The Proposed Regulations indicate that "deferred deduction" compensation is any compensation for which a payor is entitled to a deduction in a later taxable year; "applicable individual" compensation is any compensation which is not "deferred deduction" compensation.
- <sup>7</sup> Generally, employees covered by this provision include any individual other than an independent contractor who is an officer, director or employee of a CHIP or performs services for or on behalf of a CHIP.
- <sup>8</sup> The Proposed Regulations provide that two or more taxpayers will generally be treated as a single employer if they are treated as a single employer under section 414 of the Code.

The Proposed Regulations also except reinsurance contract premiums and direct service payments<sup>9</sup> from the deduction limitation.

Finally, the Proposed Regulations provide that an employer (other than a captive insurance company) will not be a CHIP solely because it sponsors a self-insured medical reimbursement plan.<sup>10</sup>

#### **IV. “Applicable Individual” Status and Exceptions**

The \$500,000 deduction limitation generally applies to payments by a CHIP to any individual who is an officer, director or employee of the CHIP, or who provides services for or on behalf of a CHIP.

The Proposed Regulations specifically exclude from the \$500,000 deduction limitation compensation paid to independent contractor service providers. Generally, an unrelated service provider will be considered an independent contractor if the service provider is actively engaged in a trade or business of providing services to others and providing “significant services” to two or more non-related persons.

In addition, the preamble to the Proposed Regulations indicate that no entity classified as a corporation or partnership for federal income tax purposes providing services to a CHIP will be covered by the \$500,000 deduction limitation. However, the preamble invites comments on how to ensure individuals do not abuse this exception by forming small single-member personal service corporations or similar entities to circumvent the deduction limitation.

#### **V. Timing and Application of the Deduction Limitation**

The Proposed Regulations provide that the services performed by an employee for a CHIP relate to the taxable year of the CHIP in which the employee obtains a legally binding right to the compensation. For example, if, in Year 1, the CHIP pays an employee \$400,000, but the employee also earns \$200,000 in deferred (but not vested) compensation in such year that is payable in Year 3, the CHIP can only deduct \$100,000 of the \$200,000 in deferred compensation when it pays the deferred compensation in Year 3 because the compensation relates to services provided in Year 1 (when \$400,000 in compensation was already paid). However, if an employee actually receives compensation exceeding \$500,000 in a taxable year, then the deduction limit applies first to any such compensation exceeding \$500,000, and then to any amounts of deferred compensation paid out in such taxable year.

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<sup>9</sup> Direct service payments are any earnings that a health insurance issuer receives from directly providing or arranging the provision of services by medical service providers.

<sup>10</sup> 78 Fed. Reg. 19950, 19952 (Apr. 2, 2013).

Finally, in the case of aggregate compensation paid to an employee by two or more members of an Aggregated Group that exceeds \$500,000, the deduction limitation is applied to each member in proportion to amounts of compensation paid by each member of the Aggregated Group.

#### **VI. Conclusion**

The Proposed Regulations present many complex issues important both to health insurers and their employees, as well as to any organization that is an affiliate of a health insurer. Concerned parties are encouraged to submit comments on the Proposed Regulations no later than July 1, 2013.

If you have any questions about the foregoing, please contact Linda Swartz, Shane Stroud, Brian McGovern, or any other member of our [Tax Department](#) or [Health Care Group](#).

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