Skadden

Executive Compensation and Benefits Alert

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Proposed Regulations Highlight the Complexity of the $500,000 Deduction Limit for Compensation Paid by Health Insurance Providers

On April 1, 2013, the Internal Revenue Service issued proposed regulations providing guidance on the $500,000 deduction limit for compensation paid by certain health insurance companies to their employees. Because of the complexity of these rules, we recommend contacting counsel for advice on compliance with the rules if your company potentially qualifies as a covered health insurance provider. While this deduction limit is part of Section 162(m) of the Internal Revenue Code (the Code), the coverage and application of these rules differ significantly from the more common applications of Section 162(m) and therefore a thorough analysis is required even if your company is otherwise exempt from, or in compliance with, Section 162(m).

Deduction Limitation

Section 162(m)(6) prohibits "covered health insurance providers" (CHIPs) and their affiliates from deducting compensation in excess of $500,000 paid to an employee (the rule also covers directors and certain independent contractors). The deduction limitation applies to compensation earned in 2010 or later and deductible in 2013 or later.

Which Companies Are Covered?

A health insurance issuer is a CHIP for years beginning in 2013 if at least 25 percent of the gross premiums that the issuer receives from providing health insurance coverage are from minimum essential coverage (as defined in Section 5000A(f) of the Internal Revenue Code). In determining gross premiums, all premiums are included, except for capitated, periodic or other payments (referred to as direct service payments) made by a health insurance issuer to a third party as compensation for providing, managing or arranging for the provision of health care services, and any premiums received by reinsurers under an indemnity reinsurance contract. Unlike Section 162(m) generally, which applies only to public companies, Section 162(m)(6) applies to all health insurance issuers, including privately held companies and partnerships as well as publicly traded companies. Each member of an affiliated group that includes a health insurance issuer is also a CHIP even if the member is not itself a health insurance issuer and does not provide health insurance coverage. In order to alleviate the burden on groups or companies that own only a small (relative to overall revenues) health insurance issuer, an entity will not be considered a CHIP if the premiums received from providing minimal essential coverage are less than 2 percent of the gross revenues of the entity and its affiliates. The proposed regulations clarify that an employer is not a CHIP solely because it maintains a self-insured medical reimbursement plan.

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Which Individuals Are Covered?

In another significant departure from the application of Section 162(m) generally, which applies only to certain executive officers, the deduction limitation of Section 162(m)(6) generally applies to all officers, directors, employees, and other individuals who provide services to or on behalf of a CHIP during a taxable year. However, independent contractors whose compensation is exempt from Section 409A of the Code (which generally exempts contractors who provide services to multiple, unrelated customers) are not covered.

Which Compensation Is Covered?

Unlike Section 162(m) generally, which does not apply to certain qualified performance-based compensation, the deduction limitation of Section 162(m)(6) applies to all compensation of a covered individual, including equity awards and other performance-based compensation, commissions, compensation payable under existing contracts and deferred compensation.

Application of the $500,000 Deduction Limit

The $500,000 deduction limit imposed by Section 162(m)(6) is applied based on the year in which the compensation is earned – not the year in which it is otherwise deductible, which is different from the general application of Section 162(m). The deduction limit for any taxable year is first applied to any compensation attributable to services performed by the individual in the taxable year at issue, then to any deferred compensation in the first taxable year in which it becomes deductible, and finally, to any deferred compensation in subsequent taxable years in which it becomes deductible. Therefore, if compensation earned for services performed by a covered individual in a taxable year exceeds $500,000, the CHIP may not deduct the excess compensation regardless of when and how such excess amount is paid, *e.g.*, it is not deductible even if it is paid in a subsequent taxable year during which the individual's compensation does not exceed $500,000 or after the individual ceases to be employed by the CHIP.

For example, assume that for 2013 services an employee of a CHIP earns $400,000 in salary (payable in 2013) and a $300,000 bonus (deferred under a nonqualified deferred compensation plan and payable in 2017). In 2013, the CHIP may deduct the entire $400,000 salary because it does not exceed the $500,000 deduction limit. However, in 2017 (the year the CHIP pays the $300,000 bonus that was deferred), because the aggregate compensation attributable to services performed in 2013 ($700,000) exceeds the $500,000 deduction limit by $200,000, the CHIP can only deduct $100,000 of the $300,000 payment (the amount remaining under the $500,000 cap for 2013 services) and the remaining $200,000 is not deductible in any year.

The proposed regulations include complicated rules prescribing how compensation is to be allocated to a particular taxable year for purposes of calculating the deduction limit. Generally, compensation is attributable to services performed by an applicable individual in the taxable year of the CHIP in which the individual obtains a legally binding right to the compensation. However, the proposed regulations require that compensation falling in certain categories, including those described below, be attributed under special allocation methods.

- **Account Balance Plans**. Compensation attributable to a taxable year will be based on the increase in the account balance during the taxable year (the "standard attribution method"). CHIPs may also use an alternative method pursuant to which earnings and losses are attributed to the taxable year in which the related principal amount is contributed to the plan.

- **Non-Account Balance Plans**. Compensation attributable to a taxable year will be based on the increase in the present value of the individual's benefit under the plan during the year.

- **Options, Restricted Stock, Restricted Stock Units (RSUs)**. Compensation relating to options is attributable on a daily *pro rata* basis over the period beginning on the date of grant and ending on the date the option is exercised. Compensation relating to restricted stock is attributable on a daily *pro rata* basis over the period beginning on the date the individual obtains a legally binding right to the restricted stock and ending on the earliest

of the date the substantial risk of forfeiture lapses with respect to the restricted stock or the date the restricted stock is transferred. Compensation relating to RSUs is attributable on a daily *pro rata* basis over the period beginning on the date the individual obtains a legally binding right to the RSU and ending on the date of payment.

- **Involuntary Separation Pay**. Involuntary separation pay is attributable to the taxable year in which the separation from service occurs. Alternatively, CHIPs may use a different method pursuant to which separation pay will be attributable on a daily *pro rata* basis to the period beginning on the date the individual obtains a legally binding right and ending on the date of separation from service.

- **Special Rule for Compensation Subject to Substantial Risk of Forfeiture**. The proposed regulations require the use of a special allocation method for unvested amounts under account balance plans and non-account balance plans (and certain other amounts). Under the special allocation method, compensation that is subject to a substantial risk of forfeiture or "vesting" is first attributed in accordance with the rules described above. The compensation attributable to the period during which it was unvested is then reattributed, on a daily *pro rata* basis, to the period beginning on the date the individual obtains the legally binding right to the compensation and ending on the date on which the compensation was no longer subject to a substantial risk of forfeiture. For example, on January 1, 2016, an employee begins participating in an account balance plan. The balance is payable on January 1, 2019, if the employee remains employed through December 31, 2017 (so that the amount credited to the employee's account is unvested until that date). The employee's account is credited with $10,000 annually for three years on January 1 of each year. The account earns interest at a fixed rate of 5 percent per year, compounded annually. Thus, the employee's account balance is $10,500 on December 31, 2016; $21,525 on December 31, 2017; and $33,101 on December 31, 2018. Using the standard attribution method for account balance plans, $10,500 of deferred compensation is attributable to services performed by the employee in 2016, $11,025 is attributable in 2017 and $11,576 is attributable in 2018. Under the special rule for compensation that is unvested or subject to a substantial risk of forfeiture, the $21,525 ($10,500 + $11,025) that relates to the unvested years of 2016 and 2017 must be reattributed on a daily *pro rata* basis over those two years, and $10,762.50 is attributed to each of 2016 and 2017.

- **Rule for Pre-2010 Compensation**. Since the deduction limit applies to compensation attributable to services performed after January 1, 2010, the proposed regulations provide specific attribution rules to determine whether compensation is attributable to a taxable year beginning before January 1, 2010.

Effect of Corporate Transactions on CHIP Status

The proposed regulations provide that if a company that is not a CHIP would become a CHIP solely as a result of a corporate transaction, the company will not be treated as a CHIP for the taxable year in which the transaction occurs. However, this transition relief does not apply to a company that was a CHIP before the transaction.

Effective Date

The proposed regulations apply to compensation earned for taxable years beginning on or following January 1, 2013. The deduction limit also applies to compensation attributable to services performed in 2010, 2011 or 2012, but deducted on or following January 1, 2013, if the health insurance issuer was a CHIP in both the year the services were performed and the year the compensation is otherwise deductible. The deduction limitation does not apply to compensation attributable to services performed before January 1, 2010, regardless of when the compensation is deducted.

Attorney contacts appear on the next page.

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