IRS issues final regulations on $500,000 compensation deduction limitation for health insurance providers

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In brief

The IRS issued final regulations on the Affordable Care Act (ACA)’s $500,000 limit on the deduction for compensation paid to service providers of a covered health insurance provider (CHIP) under Code section 162(m)(6). The final regulations largely adopt the approach taken in the proposed regulations. The regulations provide new guidance on:

- The scope of the exclusion for employers that self-insure certain medical coverage
- The application of the rules to entities that receive payment from government entities in connection with providing benefits under government-sponsored health care programs
- An exclusion from the rules for certain captive insurance companies
- The allocation of deferred deduction remuneration to the years in which services were performed

In detail

Background

Section 162(m)(6) was enacted in 2010 as part of the ACA to limit the compensation deduction that may be taken by certain health insurance providers. The deduction for compensation paid to employees, officers, board members and certain independent contractors by the aggregate group of employers that includes a CHIP is limited to $500,000 per year for tax years beginning after December 31, 2012. IRS Notice 2011-2 provided preliminary guidance and requested comments on certain issues, and proposed regulations issued in 2013 provided additional guidance concerning which health insurance providers are subject to the limitation, certain exclusions, and the mechanics of applying the limitation over multiple years. These final regulations adopt many of the positions taken in the proposed regulations and provide some additional flexibility in allocating deferred deduction remuneration to prior years.

What is a CHIP?

For tax years beginning after December 31, 2012, a health insurance issuer is a CHIP for a tax year if no less than 25% of its gross premiums from providing health insurance coverage are from minimum essential coverage, as defined under ACA, which generally includes any employer-sponsored coverage, as well as governmental coverage and coverage offered in the individual market in any state.
The compensation limit applies to all entities in the aggregate group. For these purposes, the aggregate group includes parent-subsidiary controlled groups, affiliated service groups and non-corporate entities under common control; a brother-sister controlled group is not an aggregate group under the proposed regulations. The final regulations affirm that if one entity in an aggregate group is a CHIP, the $500,000 limit applies to compensation paid to employees, directors, etc. of each entity in that aggregate group. The final regulations provide guidance on situations where the original parent entity in the aggregate group ceases to be part of the aggregate group or when that parent entity has a short tax year.

De minimis premiums rule

The final regulations continue to provide an exception for de minimis premiums that is substantially the same as the exception provided in earlier guidance. Under this exception, an aggregate group that would otherwise be a CHIP is not subject to the limitation if the premiums for minimum essential coverage received by all members of the aggregate group are less than two percent of the gross revenue of the aggregate group for the tax year. In addition, the final regulations provide that the deduction limit will not apply in the first year premiums exceed two percent of gross revenues if the aggregate group qualified for this exclusion for the prior tax year.

Observation

The IRS noted that these third parties may not qualify as health insurance issuers and thus would not be subject to section 162(m)(6). If the third party is a health insurance issuer, then amounts received from government entities will be included in the measure of premiums for purpose of determining if the entity is a CHIP and if the aggregate group qualifies for the de minimis exception.

Captive insurance companies

The final regulations provide an exclusion for captive insurance companies that receive an individual exemption from the Department of Labor (DOL) for a captive insurance company that provides reinsurance to an unrelated insurance company that directly insure the health risks of the plan sponsor’s employees. Under this arrangement, an employer purchases health insurance for its employees through an unrelated insurance company and that insurance company then reinsures the health risks through the employer’s captive under an indemnity reinsurance arrangement.

Observation

Captives that rely on the DOL’s class exemption where the captive directly insures the employee benefit plan risks of a related employer are not eligible for this exclusion from 162(m)(6), and amounts received by the captive are treated as premiums in applying the de minimis test.

How does the limit apply?

The regulations distinguish between ‘applicable individual remuneration’ and ‘deferred deduction remuneration.’ Applicable individual remuneration is compensation that is generally earned, paid and deducted in the same year, such as salary. Certain bonuses that are paid within 2 1/2 months after the end of the tax year and that are deducted in the earlier year are also included in applicable individual remuneration. Deferred deduction remuneration (DDR) is remuneration earned in one tax year that is deductible in a later tax year, such as nonqualified deferred compensation.

The regulations provide that the $500,000 deduction limit applies first to the applicable individual’s applicable individual remuneration, and if the applicable individual remuneration is less than $500,000 for the tax year, the remaining amount applies to DDR earned in that year. If, for example, an applicable individual is paid salary and bonus of $400,000 in 2015 and also receives a vested award of nonqualified deferred compensation of $600,000 to be paid in 2017, the $400,000 of salary is fully deductible under section 162(m)(6), leaving $100,000 to be applied to the nonqualified deferred compensation (the DDR) when it would otherwise be deductible. Thus,
in 2017 when the payment is made, only $100,000 of the deferred compensation is deductible by the CHIP. The balance of $500,000 of deferred deduction remuneration is not deductible even if the entity is not a CHIP in 2017, because it was earned in a year when the entity was subject to the rules.

**Allocation of deferred deduction remuneration**

DDR is generally remuneration that is not earned, paid and deducted in a single tax year. It includes traditional deferred compensation, severance, stock options and long term incentive plans. DDR must be allocated to the tax years in which the employee’s services were performed and the $500,000 compensation limit for a given tax year is applied to the portion of the compensation allocated to that year.

The final regulations make some changes to the rules for allocating the deduction to the service years. The regulations keep the general rule that compensation must first be allocated to the service years and then reallocated to take into account any vesting provisions. If there is a choice among allocation methods, the CHIP must apply the same method to all such compensation on a consistent basis. However, the regulations allow a transition period for acquired companies that track DDR on a different method than that of the new aggregate group.

**Account balance plans**

The final regulations adopt two methods for allocating DDR under an account balance plan: the ‘account balance ratio’ method and the ‘principal additions’ method. The account balance ratio method allocates the deductible amount to each year the individual provided services and in which the account balance increased. The deduction is allocated based on the ratio of the increase in the account balance for that year over the total increases in the account balance for all years in which the individual provided services. For example, assume contributions are made to an account in the amount of $10,000 in 2014 and again in 2016. Further assume that the ending balance on December 31, 2016 of $20,974 is paid on January 1, 2017. The account earns $500 in 2014 but declines in value to $9,975 in 2015. Due to the decline in value in 2015, the deduction is allocated only to 2014 and 2016. The account increased in 2014 by $10,500 and in 2016 by $10,474. The $20,974 deduction is allocated to 2014 by the ratio of $10,500/$20,474, or $10,499; the deduction is allocated to 2016 by the ratio of $10,474/$20,474, or $10,474. If the employee’s applicable individual remuneration in 2014 was $400,000 and no other DDR is allocated to 2014, the entire $10,499 of DDR for 2014 may be deducted when paid; similarly, the 2016 amount is compared to the amount compensation already allocated to 2016, to determine the amount deductible in 2017 when the deferred compensation is paid.

The regulations also allow the use of the principal additions method for account balance plans, but only if the plan can track income and losses to the specific plan contribution. Under the principal additions method, earnings on a principal amount, including post-termination earnings, are attributed to the tax year in which the individual’s account is credited with the principal amount. Under this method, the plan would have to track the principal and the related earnings or loss through to distribution.

**Nonaccount balance plans**

The regulations change the methods for allocating DDR for nonaccount balance plans: the ‘present value ratio’ method and the ‘formula benefit ratio’ method. The present value ratio method attributes a deduction to each of the taxable years based on the ratio of the increase in the present value of the individual’s benefit for the year to the sum of all such increases for all taxable years in which the individual was a service provider.

The formula benefit ratio method is based on the year-over-year increases in the individual’s final benefit and does not require a calculation of the present value of the benefits. Under this method, remuneration is allocated to each year of service in which there was an increase in the accrued benefit. The deduction is allocated to each year of service based on the ratio of the increase in the benefit during the year to the total increases in the benefit.

**Stock-based compensation**

The final regulations keep the general rule that stock-based compensation, including stock options, stock appreciation rights (SARs), restricted stock and restricted stock units, must be attributed on a daily pro rata basis to service performed by the applicable individual from the grant date until the date the compensation is paid (e.g., the exercise of the option or vesting of restricted stock). The regulations add an alternative method for options and SARs that attributes the compensation over the period from grant until vesting, which would align the tax allocation with the financial accounting expense accrual. The IRS did not provide any special rules for equity that vests in connection with a corporate transaction. The deduction relating to equity compensation that vests and is cashed out in a transaction would be allocated based on the vesting period (which would be the same period as grant through the payment date).
Observations
The requirement to allocate DDR backwards to prior years based on the amount of the ultimate deduction will be difficult for many entities to administer each year. Having then to reallocate the deduction for the vesting period on a daily pro rata basis would not seem to result in a significant movement of deduction dollars from one year to another and adds significant complexity to the rules. Because the aggregate group has to apply the rules on a consistent basis, companies must take careful steps to ensure that all members of the aggregate group adopt the same approach.

Effective date
The regulations are effective for tax years beginning after September 23, 2014. Taxpayers may rely on the final regulations for tax years beginning on or before that date.

The takeaway
The final regulations are not significantly different than the proposed regulations, except with respect to the allocation of DDR for account and nonaccount balance plans. Nevertheless, the rules are still very complex and will require careful recordkeeping. Employers must review their current methodology as established under the guidance of the proposed regulations and make any necessary changes to comply with the final regulations, and must assure that all members of their aggregated group apply the same approaches and monitor these deduction limitations as required.

Let’s talk
For more information, please contact our authors:

Susan Lennon, Washington, DC
(202) 414-4625
susan.m.lennon@us.pwc.com

Amy Lynn Flood, Philadelphia
(267) 330-6274
amy.lynn.flood@us.pwc.com

or your regional Human Resource Services professional:

US Practice Leader
Scott Olsen, New York
(646) 471-0651
scott.n.olsen@us.pwc.com

Charlie Yovino, Atlanta
(678) 419-1330
charles.yovino@us.pwc.com

Craig O’Donnell, Boston
(617) 530-5400
craig.odonnell@us.pwc.com

Pat Meyer, Chicago
(312) 298-6229
patrick.meyer@us.pwc.com

Terry Richardson, Dallas
(214) 999-2549
terrance.f.richardson@us.pwc.com

Todd Hoffman, Houston
(713) 356-8440
todd.hoffman@us.pwc.com

Carrie Duarte, Los Angeles
(213) 356-6396
carrie.duarte@us.pwc.com

Ed Donovan, New York Metro
(646) 471-8855
ed.donovan@us.pwc.com

Bruce Clouser, Philadelphia
(267) 330-3194
bruce.e.clouser@us.pwc.com

Jim Dell, San Francisco
(415) 498-6090
jim.dell@us.pwc.com

Scott Pollak, San Jose
(408) 817-7446
scott.pollack@saratoga.PwC.com

Nik Shah, Washington Metro
(703) 918-1208
nik.shah@us.pwc.com