SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2011 – Volume 7 Issue 2

IRS ISSUES NOTICE 2011-02 IN CONNECTION WITH THE NEW $500,000 COMPENSATION DEDUCTION LIMIT

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Section 162(m)(6) of the Internal Revenue Code (the "Code"), which was added to the Code in 2010 as part of the Patient Protection and Affordable Care Act, limits the deductibility of any compensation paid by certain health insurers to an individual (generally an officer, director or employee) to $500,000 per year beginning after 2012. According to one of the principal authors of this new provision of the Code, the provision was enacted in order to prevent insurance companies, and insurance executives, from profiting when millions of new customers purchased health insurance for the first time as a consequence of health care reform.[1] The immediate concern with section 162(m)(6) was that it could potentially reach beyond traditional health insurance companies and apply to life insurance companies, or highly diversified companies, with legacy health insurance business and/or that currently sell relatively small amounts of health insurance or other specialty insurance products. On Dec. 22, 2010, the Internal Revenue Service (IRS) issued Notice 2011-02 (the "Notice"), which answered many, but not all, of the questions raised by section 162(m)(6). Importantly, it also generally limited the scope of the section to traditional health insurance companies.

BACKGROUND

By way of background, section 162(m)(6) generally limits the compensation deduction to $500,000 per year for services provided by an officer, director and employee of "covered health insurance providers" ("CHIPs"). The definition of a CHIP is dependent upon the tax year in question. For taxable years beginning after Dec. 31, 2009 and before Jan. 1, 2013, a CHIP is a health insurance issuer that receives premiums from providing health insurance coverage.[2] Health insurance coverage is generally defined as benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract or health maintenance organization contract offered by a health insurance issuer.[3] Health insurance coverage does not include such products as accident or disability income insurance or any combination thereof, medical benefits that are supplementary to liability insurance, liability insurance (including general liability insurance and automobile liability insurance), workers' compensation insurance, automobile medical payment insurance, credit insurance, similar insurance coverage specified in regulations under which benefits for medical care are secondary benefits and qualified long-term care.[4]

For taxable years beginning after Dec. 31, 2012, a CHIP is any employer that is a health insurance issuer with respect to which not less than 25 percent of the gross premiums received from providing health insurance is from "minimum essential coverage." In other words, the employer must first determine which of its products fit into the health insurance "bucket" and then further determine which, if any, of those products is also considered minimum essential coverage. The definition of minimum essential coverage has been the source of much of the uncertainty surrounding section 162(m)(6) because the definition provides greater guidance on what is not such coverage than it provides with respect to what is such coverage. For example, minimum essential coverage generally includes government-sponsored programs (such as Medicare and Medicaid), plans sold in the individual market and employer-sponsored plans (generally assumed to be comprehensive major medical insurance sold in the small or large group markets in the state). The statute then goes on to exclude (to mention just a few) such items as coverage for accident or disability income insurance or any combination thereof, supplementary coverage to liability insurance, workers' compensation, automobile medical payment insurance, credit only insurance, limited scope dental or vision benefits, long-term care, nursing home care or fixed indemnity insurance, community-based care, coverage for specified diseases and fixed indemnity insurance.[5]

CONSEQUENCES UNDER SECTION 162(M)(6)

If an employer is classified as a CHIP for the taxable year, section 162(m)(6) classifies that year as a "disqualified taxable

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year."[6] As a consequence, current wages paid after Dec. 31, 2012 in a disqualified taxable year are subject to the $500,000 deduction limitation, which can have a significant adverse tax impact upon corporations with a large number of highly compensated employees. Additionally, the new law applies to deferred compensation (generally referred to as "deferred deduction remuneration"),[7] paid after Dec. 31, 2012 that is attributable to services performed during any disqualified year after Dec. 31, 2009.

THE NOTICE

Many questions, especially for the insurance industry, remained unanswered following the enactment of section 162(m)(6) and became the subject of numerous inquiries to the government. For example, if an employer was a CHIP in the year that compensation was deferred, but was not a CHIP in the year of actual payment (or vice versa), some asserted the statute was less than clear whether the $500,000 limitation applied. It also was not clear whether or how the rules applied to independent contractors, what products constituted minimum essential coverage, or how indemnity reinsurance is treated under the statute. In addition, there was dialogue with the government regarding whether there should be a *de minimis* amount to protect employers with legacy health insurance coverage and the application of the new rules to captive insurance companies and their parent companies. While the IRS did not answer all of these questions, the insurance industry is now in a much better place with the answers provided in the Notice.

Perhaps the most important provision for the life insurance industry in the Notice, which is effective for taxable years beginning on or after Jan. 1, 2010, is the creation of a *de minimis* rule. Accordingly, for taxable years beginning after Dec. 31, 2009 and before Jan. 1, 2013, an employer is not a CHIP if premiums received from providing health insurance coverage are less than 2 percent of the employer's gross revenues for that taxable year.[8] It is important to note that the Notice does not provide a definition of gross revenues for this purpose. For taxable years beginning after Dec. 31, 2012, an employer is not a CHIP if premiums received from providing health insurance that is minimum essential coverage are less than 2 percent of the employer's gross revenues for that taxable year. This *de minimis* rule will likely exempt most legacy health insurance business and possibly small blocks of specialty products where it is not clear whether such products constitute minimum essential coverage.

Additionally, with respect to the proper treatment of deferred compensation, the Notice makes it clear that an employer must be a CHIP in the year of deferral and in the year of actual payment of the deferred compensation in order for the deduction limits to apply.[9] In other words, if the employer is a CHIP in the year of deferral, but has intervening years where the employer is and is not a CHIP, the compensation deduction limit will only apply if the employer is again a CHIP in the year in which the deferred compensation is actually paid. Simply becoming a CHIP in the year of deferral is of no consequence unless the employer becomes a CHIP at a later date.[10]

The Notice also clarifies that certain independent contractors (*i.e.,* those providing substantial services to multiple unrelated customers) are not subject to the compensation deduction limitations[11] and that indemnity reinsurance premiums are not treated as premiums from providing health insurance coverage.[12]

WHAT IS MISSING FROM THE NOTICE?

Absent from the Notice is further clarification regarding the definition of minimum essential coverage, which means that insurers with specialty insurance products must independently determine the impact of the new rules on those products. The Notice does not provide guidance regarding so-called stop loss insurance, although the IRS did recognize that guidance was necessary because the Notice specifically requested comments on the application of the rules to issuers of stop loss insurance arrangements with a low attachment

point.[13] The Notice did not provide guidance about captive insurance companies but again requested comments regarding the application of the new rules to captive insurers, along with requests for comments on the meaning of a CHIP in the case of a corporate event such as a merger, acquisition or reorganization and possible alternative *de minimis* rules. Comments on these issues must be submitted by March 23, 2011.

CONCLUSION

While the Notice did not answer every possible question, it did exclude many of the products and fact patterns that caused a great deal of concern when section 162(m)(6) was enacted. There are still outstanding questions, but it is clear from the request for comments that the IRS is focused on the issues most in need of resolution for the insurance industry. Finally, obtaining this guidance before year-end was critical because companies to which the exceptions in section III of the Notice applied would otherwise have had to accrue, in their 2010 financial statements, for "deferred deduction remuneration" earned in 2010 payable after 2012.

END NOTES

1 *See* Dec. 4, 2009 press release issued by Senator Blanche Lincoln (D-AR).
2 Under IRC section 9832(b)(2), a health insurance issuer is generally defined as an insurance company that is licensed to engage in the business of insurance in a state and that is subject to a state insurance regulation. The term does not include a group health plan. Additionally, entities that are aggregated under section 414 of the Code are generally treated as a single entity for these purposes, which can pull noninsurance subsidiaries into the scope of the new rule.
3 *See* IRC section 9832(b)(1) of the Code.
4 *See* IRC sections 9832(c)(1) & (d) and 213(d) of the Code.
5 *See* IRC sections 162(m)(6)(i)(II) and 5000A(f) and 42 USC 300gg-91(c)(1).
6 See IRC section 162(m)(6)(B).
7 *See* IRC section 162(m)(6)(A)(ii) and (E).
8 *See* section III(B) of the Notice.
9 *See* Examples 1 & 2 under section III(A) of the Notice.
10 *See* Example 3 under section III(A) of the Notice.
11 *See* section III(C) of the Notice.
12 *See* section III(D) of the Notice.
13 *See* section IV of the Notice.