

December 29, 2010

IRS Issues Guidance on the Deduction Limitation of Code Section 162(m)(6)

On December 23, 2010, the Internal Revenue Service issued Notice 2011-2, providing long-awaited guidance on the application of Internal Revenue Code (Code) section 162(m)(6) as added by the Patient Protection and Affordable Care Act (PPACA). The guidance provides that:

- The section 162(m)(6) deduction limitation will apply to deferred amounts attributable to services performed prior to 2013 only if an employer is a covered health insurance provider in the year that the services were performed and the year that the compensation paid for the services is otherwise deductible by the employer;
- Under a new de minimis rule, an employer will not be treated as a covered health insurance provider subject to the section 162(m)(6) deferred deduction limitation in any year prior to 2013 if the premiums the employer receives for providing health insurance coverage are less than 2% of the employer's gross revenues for that taxable year;
- An independent contractor will not be considered an applicable individual for purposes of section 162(m)(6) if a deferred compensation arrangement for that individual would not be subject to Code section 409A; and
- Premiums received under an indemnity reinsurance contract will not be considered in determining whether an employer is subject to the deduction limitation of section 162(m)(6).

The Treasury Department and the IRS have also requested comments on the application of section 162(m)(6). The deadline for comments is March 23, 2011.

Background

Code section 162(m) generally limits the deductibility of certain compensation expenses by employers whose stock is publicly traded. Specifically, sections 162(m)(1)-(4) limit the allowable deduction for compensation paid by a publicly traded company to its chief executive officer and three highest paid officers, other than its chief financial officer, to no more than \$1 million per officer per year, with exceptions for performance-based compensation and commissions.

Section 162(m)(6) extends the section 162(m) deduction limit further. As added by section 9014 of PPACA, section 162(m)(6) imposes a \$500,000 limit on the deduction a "covered health insurance provider" may claim for remuneration payable to "applicable individuals." The term "applicable individuals" includes officers, directors, employees, and any individual who provides services to or on behalf of a covered health insurance provider during the taxable year. The term "covered health insurance provider" is subject to a bifurcated definition. For years after December 31, 2009 and prior to January 1, 2013, a covered health insurance provider includes any employer that is a health insurance issuer, which is subject to state insurance law and receives premiums from providing health insurance coverage (including certain stand-alone benefits traditionally excepted from HIPAA coverage). For years after December 31, 2012, the definition of covered health insurance provider is limited to health insurance issuers which receive not less than 25% of the company's gross health insurance premiums from providing "minimum essential coverage" as defined in Code section 5000A(f) – generally, major medical coverage. Code section 162(m)(6) applies the controlled group aggregation rules for qualified plans under section 414, with certain modifications, to make the deduction limitation applicable to all members

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of a controlled group that includes a covered health insurance provider. Thus, unlike Code sections 162(m)(1)-(4), Code section 162(m)(6) is not limited to publicly traded employers; it applies to all employees rather than just certain officers; and it includes no exceptions for performance-based compensation or commissions.

Although section 162(m)(6) is generally effective for taxable years beginning after December 31, 2012, it also limits to \$500,000 the deduction for “deferred deduction remuneration,” which is generally defined as remuneration attributable to services performed after December 31, 2009 and before December 31, 2012 that is deferred and otherwise deductible by the employer in a taxable year beginning after 2012, subject to certain carry-forward rules. For that reason, the rule has an immediate impact on certain deferred compensation payable by health insurance issuers.

Since the enactment of PPACA, the language of section 162(m)(6) has raised numerous concerns regarding its potentially wide-ranging effect. For instance, the definition of covered health insurance provider for the period 2010-2012 appears to capture insurers that issue very small amounts of health insurance during those years, and some of which may never issue any contracts for minimum essential coverage. The definition further suggests that captive insurance companies and reinsurers that write coverage to allow a health insurer to manage its risk of large losses might be subject to the \$500,000 deduction limit. In addition, the sweeping definition of “applicable individual” raised concerns that compensation received by any individual acting as a service provider to a health insurer in any capacity might be subject to the deduction limitation. Finally, the language and structure of section 162(m)(6) indicate that, if a controlled group includes a covered health insurance provider, all members of the group are subject to the reduced deduction limit.

Application to Compensation Deferred in 2010-2012

The Notice addresses certain concerns related to deferred deduction remuneration paid by insurance issuers that receive limited amounts of health insurance premiums in years prior to 2013. The Notice provides that the deduction limitation under Code section 162(m)(6) will only apply to remuneration attributable to services performed in taxable years 2010-2012 (and paid after 2012) if the employer is a covered health insurance provider under the pre-2013 definition in the year in which the services were performed, and the employer is also a covered health insurance provider under the post-2012 definition in the year in which the deferred deduction remuneration is otherwise deductible. Therefore, applying this rule, an insurer that does not issue contracts for minimum essential coverage after 2012 will not be subject to the limitation for deferred deduction remuneration attributable to services performed in 2010-2012. However, an example included in the Notice suggests that a pre-2013 covered health insurance provider that is not a covered health insurance issuer in 2013 may still become subject to the deferred deduction limitation at a later time if compensation earned prior to 2013 becomes deductible in any taxable year after 2013 in which the issuer receives at least 25% of its gross health insurance premiums from providing “minimum essential coverage.”

De Minimis Rule to Determine Covered Insurance Providers

The Notice also adds a new de minimis rule to the definition of covered health insurance provider, with one rule applicable for taxable years beginning after December 31, 2009 and before January 1, 2013, and with a somewhat different rule applicable after 2012. For 2010-2012, instead of applying Code section 162(m)(6) to all health insurance providers that issue health coverage during those years, the Notice provides that an employer will not be treated as a covered health insurance provider if the premiums it receives for providing health insurance coverage are less than 2% of the employer’s gross revenues for

that taxable year. Furthermore, an employer will not be subject to section 162(m)(6) in taxable years beginning after 2012 if its premium receipts for providing health insurance coverage that is minimum essential coverage in those years are less than 2% of the employer's gross revenues. This rule addresses the concern that an insurer that issues a very small amount of health insurance coverage would be inadvertently, and perhaps permanently, subject to the new deduction limitation.

Definition of Applicable Individual

The Notice also excludes certain independent contractors from the definition of "applicable individual" (*i.e.*, any individual who receives remuneration from a covered health insurance provider). However, the exclusion is limited to independent contractors for whom a compensation arrangement would not be subject to Code section 409A. Generally, this means that, to determine if the contractor is excluded from the definition of "applicable individual," the employer will need to ascertain whether the independent contractor is unrelated to the employer, is actively engaged in the trade or business of providing services, and provides "significant services" to two or more unrelated service recipients.

Application to Certain Reinsurers

The Notice also includes some relief for certain employers in the reinsurance market, stating that premiums received under an "indemnity reinsurance contract" will not be treated as premiums for providing health insurance for purposes of determining whether the employer is a covered health insurance provider and, thus, subject to Code section 162(m)(6).

Comments Requested

Even with the guidance under Notice 2011-02, several significant questions remain regarding the application of Code section 162(m)(6). Accordingly, the Treasury Department and the IRS have requested comments on the application of the Notice, as well as all aspects of the application of Code section 162(m)(6). The agencies have specifically requested guidance on the application of the deduction limit to captive insurance companies, reinsurers that do not operate in the indemnity market, and certain stop loss insurance arrangements that may constitute direct insurance because the attachment point is so low. Comments are also requested on other aspects of the definition of "covered health insurance provider," including the *de minimis* rule in the Notice, possible alternative *de minimis* rules, and how the term should be applied in the event of a corporate transaction such as a merger, acquisition or reorganization. In addition, the agencies have requested comments on whether the deferred deduction limitation allocation rules applicable to TARP companies under Notice 2008-94 should be applied for purposes of Code section 162(m)(6).



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