GROOM LAW GROUP

April 20, 2010

MEMORANDUM TO CLIENTS

RE: <u>PPACA $500,000 Compensation Deduction Limit on Health Insurers May Have Broader Reach</u>

The Patient Protection and Affordable Care Act ("PPACA") includes a number of tax provisions aimed at the health insurance industry that are intended to help pay for PPACA's costs. One little noticed provision restricts the deductibility of compensation paid by a health insurer to an individual to $500,000 per year. This provision could have immediate and unexpected consequences for diversified companies whose business includes the sale of health insurance coverage, as well as traditional health insurers.

The scope of the deduction restriction is broad – generally, any companies that are in the same "controlled group" as a health insurer (as broadly defined in PPACA) may be subject to the $500,000 limitation. And the provision will impact the deductibility of compensation for services performed beginning in 2010. Thus, any company with a "health insurer" in its controlled group should quickly become familiar with this new rule. This memorandum will outline how the new restriction operates.

Compensation Subject to the Deduction Limit

Section 9014 of PPACA added a new section 162(m)(6) to the Internal Revenue Code (the "Code") containing the $500,000 limit. While the limitation is similar to the long-standing $1 million annual compensation deduction limitation that applies to public companies under Code section 162(m), there are number of important differences summarized below.

- The PPACA provision applies to all companies meeting the "health insurer" definition (see below), regardless of whether they are publicly traded.
- While the $1 million limit applies to, at most, the top five executives at a public company, the PPACA limitation applies to all individuals who provide services to a health insurer. This means that payments to department heads and other high level employees, as well as outside directors, consultants and other independent contractors, are subject to the limit.
- While exempt from the $1 million limit, commissions and "performance-based compensation" will be subject to the PPACA limitation.
- Payments to an individual who is no longer a top five executive (e.g., after retirement) are exempt from the $1 million limit, but such amounts will be subject to the PPACA limitation regardless of when paid.

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The PPACA provision closely tracks a similar $500,000 deduction limitation that applies to financial institutions in the TARP program. Thus, IRS guidance on the PPACA provision is likely to be substantially similar to its guidance on the TARP provision.

Covered Health Insurers and Their Affiliates

The $500,000 deduction limitation applies to compensation for services provided during any year after 2009 in which a company is a "covered health insurance provider." Whether a company is a covered health insurance provider depends on whether the company receives premiums from providing "health insurance coverage" as defined in Code section 9832(b)(1). Health insurance coverage is defined under this section as benefits consisting of medical care offered by a health insurance issuer (such as an insurance company), with the following benefits excepted from the definition of health insurance coverage:

- accident and disability income insurance,
- 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-only insurance,
- on site medical clinics, and
- similar insurance coverage as provided in regulations where medical care is secondary.

Coverage for dental, vision and long-term care would be considered health insurance coverage for this purpose, as would coverage for a specific disease or illness, and hospital or other fixed indemnity insurance.

For years prior to 2013, receipt of any premiums for providing health insurance coverage, as described above, appears to render a company a covered health insurance provider subject to the PPACA limitation. For years after 2012, a company would be a covered health insurance provider if at least 25 percent of the premiums it receives from providing health insurance coverage are from providing minimum essential coverage, as that concept has been added by the PPACA. Thus, a company may be a covered health insurance provider under the pre-2013 rules but not under the narrower post-2012 rules.

The broad definition of health insurance coverage produces some unexpected results. For example, vision and dental insurance under a separate insurance policy will not be considered minimum essential health coverage under PPACA, but receiving premiums for that coverage during 2010 through 2012, causes a company (and members of its controlled group) to be subject to the $500,000 deduction limitation as the law is written. For 2013 and later years, premiums for those benefits will be disregarded in determining whether the company is a covered health insurance provider. The same would be true for companies that provide for specific disease or illness coverage or hospital or fixed indemnity insurance. The inconsistent treatment of these premiums could be a drafting error in PPACA. It appears the intent of the PPACA provision was to affect insurance companies receiving premiums for selling the health insurance coverage that was mandated under the PPACA. A company's receipt of premiums for coverage which is outside the new rules under PPACA probably should not subject the company to the deduction limit. While it is unlikely that Congressional leadership will want to acknowledge so soon after enactment that there are errors in the PPACA and provide for a legislative fix to this technical error, the regulatory agencies may find it within their discretion to provide relief when they issue guidance on this provision.

As noted above, all entities that are treated as members of the same controlled group under the qualified plan rules in Code section 414 will be treated as one employer for this purpose (with exceptions for brother-sister corporations and combined group arrangements). Absent some regulatory relief, this could mean that if one subsidiary in a controlled group received premiums from providing any "health insurance coverage" – no matter what the size of the subsidiary in relationship to the entire controlled group – all the companies within that controlled group would be subject to the PPACA deduction limitation. Also, all payments made to an individual by any member of the controlled group will need to be aggregated to determine whether the $500,000 limit is exceeded.

Application to Deferred Compensation

Companies can not get around this $500,000 limit by deferring non-deductible compensation into future years and taking a deduction at the time of payment. If an individual's compensation equals or exceeds $500,000 during a year, then any deferred compensation which relates to the services performed during the year will not be deductible in the future – even if the individual is no longer providing services to the company. If less than $500,000 is deducted on behalf of an individual during a year, then an amount of deferred compensation attributable to services performed during that year can be deducted when paid, up to the unused deduction amount.

IRS Notice 2008-94, applicable to the $500,000 limit for TARP companies, provides the following example to illustrate how the limit applies to deferred compensation: An executive was paid $400,000 in cash during 2010, and deferred until 2015 a $250,000 payment that would otherwise be paid during 2010. The $400,000 cash payment would deductible during 2010. When the deferred $250,000 is ultimately paid in 2015, only the remaining $100,000 of the $500,000 deduction amount for 2010 can be deducted. This Notice also contains rules for determining when amounts (e.g., equity awards and nonqualified plan benefits) are treated as attributable to services performed during a year for this purpose, and the PPACA guidance will likely contain similar rules.

As indicated above, a company could be subject to the $500,000 limit based on sales of many types of insurance coverage during the 2010 to 2012 period, even if it fails to qualify as a covered health insurance provider after 2012. If compensation earned at such a company during the 2010 to 2012 period is deferred and paid after 2012, it would appear to be subject to the $500,000 limit.

Effective Date

Deductions will not be limited under the PPACA provision on compensation paid until taxable years beginning after 2012. However, compensation earned after 2009 and deferred until after 2012 will be subject to the deduction limitation if the employer is caught as a covered health insurer under the very broad net that the provision casts prior to 2013 (unless and until it is corrected). Thus, employers already subject to this new limit will need to address it soon.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this or any other matter.

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