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**Executive Compensation****The Odd Couple: Health Care Reform and Executive Compensation— The Dawn of Code Section 162(m)(6)****By Susan E. Stoffer**

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It has been over 15 years since executive pay first took a hit with the genesis of Section 162(m) of the Internal Revenue Code of 1986, as amended (the code). Section 162(m) was enacted as a part of the Omnibus Budget Reconciliation Act of 1993 <sup>1</sup> and was the result of a strong political push following the 1992 election season to curb executive pay.

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<sup>1</sup> Pub. L. No. 103-66.

Under Section 162(m), a publicly held corporation (defined as a corporation with a class of common equity securities that is required to be registered under Section 12 of the Securities Exchange Act of 1934) is not permitted to deduct payments for certain employee compensation in excess of \$1 million. Originally, "covered employees" affected by this limitation were restricted under Section 162(m) to the chief executive officer of the corporation and the four most highly compensated employees other than the CEO, whose compensation is required to be reported under securities rules, as determined on the last day of the taxable year. IRS Notice 2007-49 <sup>2</sup> modified this covered employee group to the chief executive officer of the corporation, now called the principal executive officer, and the three most highly compensated employees other than the CEO, as of the end of the taxable year. The chief financial officer, now referred to as the principal financial officer, is no longer included in the definition of "covered employee."

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<sup>2</sup> 2007-30 I.R.B. 141 (July 23, 2007).

Commissions and certain "performance-based" compensation (including stock options) are excluded from being counted towards the deduction limit each year if certain shareholder approval requirements and other rules are met. The deduction limit does not apply to compensation for which a deduction is permitted after a covered employee stops being classified as such. Therefore, a deduction for compensation for which payment is deferred to a time following termination of employment is usually not limited under Section 162(m).

More limits for executive pay arrived with the Troubled Asset Relief Program (TARP) established under the Emergency Stabilization Act of 2008, <sup>3</sup> and under the American Recovery and Reinvestment Act of 2009. <sup>4</sup> For companies participating in TARP, the compensation deduction limit is reduced to \$500,000 and the exemption for performance-based compensation is removed. The TARP version of Section 162(m) is not limited to publicly held corporations. Any corporation or partnership is subject to the modified 162(m) rules if it is an employer from which a "troubled asset" is acquired by the Treasury Department. "Controlled group" aggregation rules are also applicable, meaning that a "related" employer of a TARP company could also be subject to the deduction limit (even if such employer did not participate in TARP). The "covered employee" group for purposes of Section 162(m)(5) consists of the chief executive officer, the chief financial officer, and the three most highly compensation employees, but the timing for the determination is expanded to include any day during the taxable year. Once the TARP money is repaid, the limit goes away. <sup>5</sup>

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<sup>3</sup> Pub. L. No. 110-343.

<sup>4</sup> Pub. L. No. 111-5.

<sup>5</sup> I.R.C. 162(m)(5)(D)(i), added by Pub. L. No. 110-343. See guidance in Notice 2008-94, 2008-44 I.R.B. 1070 (Nov. 3, 2008)

Now, how do we make the leap from limiting deductions for compensation for highly paid executives of publicly held corporations to executives of employers receiving financial assistance under TARP to all employees, outside directors, and independent contractors of health insurance providers? See [The Patient Protection and Affordable](#)

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Care Act, as amended by the Health Care and Education Reconciliation Act of 2010. Let's call it "PPACA."<sup>6</sup>

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<sup>6</sup> Pub. L. No. 111-148, amended by Pub. L. No. 111-152.

New code Section 162(m)(6) (Section 9014 of PPACA) provides a \$500,000 limit on compensation deductions for tax years beginning on or after Jan. 1, 2013, for "covered health insurance providers." Deductions are limited with respect to *any* compensation paid to any officer, director, or employee of a covered health insurance provider or any other individual who provides services for or on behalf of the covered health insurance provider. Deduction limitations apply to compensation paid in 2013 or later, including compensation for services provided after 2009 which is paid in 2013 or later. In other words, there is no exception for "deferred" compensation. There is also no exception for commissions or "performance-based" compensation. Controlled group aggregation rules also apply.

The amendment to Code Section 162(m) to add subsection (m)(6) is effective for tax years beginning after 2009, with respect to services rendered after such date. That means the limit may apply to compensation being earned now. No guidance has yet been issued, but the questions are mounting up.

#### **How is a "covered health insurance provider" defined?**

Section 162(m)(6)(C) defines a "covered health insurance provider" as any employer that is a health insurance issuer (as defined in code Section 9832(b)(2)), beginning with the 2010 tax year. For tax years starting after Dec. 31, 2012, this definition is limited to such health insurance issuers with at least 25 percent of gross premiums being received from providing health insurance coverage which is classified as "minimum essential coverage" under Code Section 5000A(f).

*Under Code Section 9832(b)(2), the term "health insurance issuer" means an insurance company, insurance service, or insurance organization (including a health maintenance organization) which is licensed to engage in the business of insurance in a State and which is subject to State law which regulates insurance (within the meaning of Section 514(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA)). A "health maintenance organization" means a federally qualified health maintenance organization (as defined in Section 1301(a) of the Public Health Service Act (42U.S.C. 300e(a)), an organization recognized under State law as a health maintenance organization, or a similar organization regulated under State law for solvency in the same manner and to the same extent as such a health maintenance organization.*

*"Minimum essential coverage" for purposes of the deduction limit means health insurance coverage provided under an employer-sponsored group health plan other than coverage for "excepted benefits." "Excepted benefits" are defined in Code Section 5000A(f)(3) generally as coverage for accident or disability income insurance, general liability and auto liability insurance, workers' compensation coverage, coverage for on-site medical clinics, and other similar insurance coverage (to be specified in regulations).*

*Open Issue: Are stop-loss providers included in the definition of "health insurance issuer"?*

#### **What is the effect of the change in the definition of "covered health insurance provider" starting in 2013?**

The \$500,000 compensation deduction limit starting in 2013 applies to compensation paid in 2013 or later for services rendered during any year after 2009. This would include compensation with "deferred" payment in 2013 or later. For example, a performance incentive plan that bases a bonus payment on performance for 2011 through 2012, but the bonus is not paid until 2013 would be subject to the deduction limit in 2013, the year in which the bonus is paid. The definition of "covered health insurance provider" is not limited to the 25 percent premium threshold until 2013. Therefore, it appears to be possible for an employer to be a "covered health insurance provider" under the pre-2013 rules but not under the post-2012 rules.

*Open Issue: Is this a drafting error which will be "fixed" by a "technical correction"? Will regulations "clarify" this discrepancy?*

#### **How do the controlled group rules apply?**

Applying the controlled group aggregation rules of Code Section 414(b), (c), (m) and (o) can cause related companies to be treated as a single employer. These are the same rules that apply to tax-qualified retirement plans (but here applying an exception which ignores brother-sister corporations and combined group arrangements). For example, if a corporation owns 15 hospitals and one HMO, all of the companies within that controlled group, including the parent corporation, will be subject to the PPACA limit on deductible compensation. In addition, all compensation paid to an individual by any member of the controlled group must be aggregated to determine whether or not the \$500,000 deduction limit is exceeded in a given year.

*Open Issue: Will this application of the controlled group rules lead to the break-up of previously integrated health care systems?*

#### **Are stock option grants and "performance-based" incentive plans exempt from this \$500,000 limit?**

No.

#### **Are bonus payments provided for in employment contracts entered into before the effective date of PPACA excepted from the deduction limit?**

No.

#### **Are commissions exempt from this \$500,000 limit?**

No.

#### **Will payments to an individual after termination of employment be subject to the deduction limit?**

Yes. The deduction limit cannot be avoided by deferring compensation for payment in later years. However, it should be noted that if less than \$500,000 is deducted on behalf of an individual during a tax year, then to the extent that the individual is credited with deferred compensation attributable to services performed by such individual during that year, such compensation may be able to be deducted for the year in which paid, up to the unused deduction amount.

#### **To which "individuals" is the compensation deduction applied?**

The deduction limit applies to any individual who is an officer, director, or employee of a covered health insurer. The limit also applies to any individual who provides services for or on behalf of a covered health insurer for a tax year. Unlike TARP and "regular" 162(m) rules, under PPACA, the affected group of individuals is not limited to a group of "executives." It would appear that the deduction limit would apply to brokers and consultants. Remembering the

controlled group rules, compensation deductions for executives of companies that are not health insurance providers could also be affected.

*Open Issue: Will the deduction limit apply to medical providers? Arguably, professional corporations will not be treated as "individuals."*

Unfortunately, many questions are raised for which we do not yet have guidance. However, it is not too early for any employer to determine whether a "covered health insurance provider" lurks within its controlled group mist and to begin looking at how it will attract and keep highly qualified executives on its team given the application of new code Section 162(m)(6).

**Exhibit A. APPLICATION OF CODE § 162(m)**

	<b>"Original" §162(m)</b>	<b>"TARP" §162(m)(5)</b>	<b>"Health Insurers" §162(m)(6)</b>
Compensation Deduction Limit	\$1 million (§162(m)(1)) and Treas. Reg. § 1.162-27	\$500,000 (§162(m)(5)(A)) Applies for any tax year during which any obligation arising from the receipt of financial assistance under TARP is outstanding (IRS Notice 2008-94)	\$500,000 (§162(m)(6)(A))
Application to Employers	Publicly held corporations (§162(m)(2)) and Treas. Reg. §1.162-27(c)	Any employer with one or more troubled assets acquired under the TARP program and aggregate amount of such assets exceeds \$300 million (§162(m)(5)(B))	Covered health insurance providers (§162(m)(6)(C)), defined as a health insurance issuer under §9832(b)(2)
Covered Employees	Principal executive officer of the corporation and the three most highly compensated employees other than the PEO, determined as of the last day of the tax year (IRS Notice 2007-49)	Chief executive officer, chief financial officer and the three most highly compensated employees, at any time during the tax year (§162(m)(5)(D))	Applicable individual who is an officer, director or employee during the tax year, and each individual who provides services for or on behalf of a covered health insurance provider during the tax year (§162(m)(6)(F))
Application to Controlled Group	A publicly held corporation includes an affiliated group of corporations, as defined in I.R.C. §1504 (Treas. Reg. §1.162-27(c)(1)(ii))	Yes, applying the I.R.C. §414(b), (c), (m) and (o) rules (§162(m)(5)(B)(iii)), controlled group companies treated as a single employer	Yes, applying the I.R.C. §414(b), (c), (m) and (o) rules (§162(m)(6)(C)(ii)), controlled group companies treated as a single employer
Exempt Compensation	Commissions; performance-based compensation; compensation payable under a written binding contract in effect on Feb. 17, 1993, and not materially modified thereafter (§162(m)(4)(B), (C) and (D) and Treas. Reg. §1.162-27(d) and (e))	None (§162(m)(5)(E))	None (§162(m)(6)(D))

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