CHIPping Away at Deductions on Employee Compensation

It should be pointed out that medical reimbursement plans that are self-insured through a trust or the general assets of a company are excepted from the rules, and therefore not treated as CHIPs.

The Captive Snag

To illustrate how a company might find itself in a surprising situation, consider this example.

The Jackson Company ("Jackson") provides technology consulting services to the energy industry. Jackson has established a captive insurance company ("Captive") to insure the risks associated with the medical benefits provided to employees of Jackson. Captive, which is subject to state regulation, receives premiums from Jackson (funded in part by Jackson and in part via employee payroll deductions) during the year of $5 million, all of which relate to providing minimum essential coverage. In the ordinary course of its consulting business, Jackson produces $195 million of revenue during the year. Assume that Jackson and Captive are the only two entities in the aggregated group.

Because the premiums received by Captive ($5 million) represent 2.5 percent (more than the 2 percent de minimis threshold) of the gross revenues of the aggregated group ($200 million — $195 million from Jackson and $5 million from Captive), the de minimis exception cannot be invoked. In addition, since more than 25 percent (100 percent) of Captive's revenue is attributable to providing minimum essential coverage, Jackson and Captive are both treated as CHIPs. Therefore, compensation paid to any employee of Jackson or Captive is not deductible to the extent it exceeds $500,000.

It should be noted that the proposed regulations include a one-year grace period related to the de minimis exception. For example, if Jackson was not treated as a CHIP in year 1 solely because it invoked the de minimis exception, it will not be treated as a CHIP in year 2 if it fails to meet the de minimis exception the subsequent year.

How the Proposed Regulations Differ From Prior Regulations

Many tax practitioners are familiar with Section 162(m). However, as mentioned earlier, the proposed rules differ significantly in scope and application from the original Section 162(m) rules, and in many ways are similar to the special limitations imposed on Troubled Asset Relief Program (TARP) recipients by Section 162(m)(5). The chart below illustrates the differences in application.

As shown above, the proposed regulations (summarized in the rightmost column, under the heading "Health Insurers" §162(m)(6)) apply to all companies that are CHIPs, not just public companies as the broader Section 162(m) rules do. In addition, the proposed regulations cover all employees, as opposed to other areas of Section 162(m), which cover only select members of senior management. Like the TARP Section 162(m) rules, no compensation is exempt from the limitation, even if it is performance-based.

How the Proposed Regulations Work

Unlike the general application of Section 162(m), the $500,000 deduction limit imposed by Section 162(m)(6) is applied based on the year in which the compensation is earned (versus the year in which it would otherwise be deductible).

Continuing from the prior example, assume the Jackson Company, a CHIP, pays Brian, an employee, $400,000 in salary for services performed in 2013. In addition, Brian earns a $300,000 bonus, payable upon December 31, 2013, but for the fact that Brian chose to defer the bonus under a nonqualified deferred compensation plan. As a result of the deferral, the bonus will be paid to Brian in 2017.

Under the "original" Section 162(m) rules, the $400,000 in salary would be tested against the $1 million deduction limitation for 2013, while the $300,000 bonus would be tested against the $1 million deduction limitation for 2017 (the year in which it is paid). However, under the new Section 162(m) rules applicable to CHIPs, both the $400,000 in salary and the $300,000 bonus would be tested against the $500,000 deduction limitation for 2013. Therefore, when the $300,000 bonus is paid in 2017, only $100,000 will be able to be deducted for tax purposes ($500,000 allowed deduction related to 2013 services, less $400,000 in salary already deducted).

The proposed regulations contain special attribution rules for account balance plans, non-account balance plans and long-term incentives (i.e., stock options, restricted stock and restricted stock units). For example, the attribution rules for stock options prescribe that compensation arising from the exercise of stock options is attributable on a daily pro rata basis over the period beginning on the date of grant and ending on the date the option is exercised. Such complex attribution rules require meticulous record keeping and thorough calculations to determine allowable tax deductions for employee compensation.

Alvarez & Marsal Taxand Says:

The proposed Section 162(m) regulations applicable to covered health insurance providers — CHIPs — bring many complexities to the forefront for tax, human resource and accounting professionals. Of note, companies should immediately consider:

- Whether or not the proposed regulations will affect them. For companies that are not health insurance issuers, consideration should be given to whether the presence of a captive insurance company that insures minimum essential benefits would cause all members of the aggregated group to be treated as covered health insurance providers. If a captive is expected to cause the aggregated group to be treated as CHIPs, consideration should be given to self-insuring employees' medical benefits.
- Performing sensitivity analyses within the tax department to determine the approximate value of the deduction that will be lost as a result of the proposed rules, as well as updating forecasts.
- Whether there are appropriate systems and processes in place to track which compensation is deductible vs. non-deductible. As discussed, certain elements of compensation may be "earned" across many years. Further, the year in which the compensation is potentially deductible may occur many years following the year in which the compensation is "earned." Therefore, it is of utmost importance to have procedures and controls in place to track compensation.
- Whether the proposed regulations warrant examining and adjusting the overall compensation strategy and philosophy of the organization.

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