How ACA Section 162(m)(6) Impacts Company Revenue and Executive Compensation

Finding Balance When Your Gain is Their Loss

An Informative White Paper for For-Profit Health Insurance Companies and Affiliates

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The need to stem health care costs is one of the most stubborn challenges U.S. policymakers have confronted in decades. Consider this: for a family of four between 2008 – 2018, average total health care costs (employee and employer contributions) shot up 54.7 percent[1], an unsustainable rise.

To address this rising cost, worsened by diminished coverage, the Patient Protection and Affordable Care Act (ACA) was enacted in March 2010. We believe it is essential for you to become aware of a critical niche within the ACA niche—a provision added by the ACA, Internal Revenue Code Section (§) 162(m)(6).

Congress anticipated that the ACA would propel new revenues to providers in private-sector health insurance. Section 162(m) (6) was viewed as a 'tradeoff.' In exchange for the increased revenues, for-profit health insurers must lower their annual compensation deduction per employee from $1 million to $500,000. This new threshold increases revenue to the federal government to offset the overall cost of ACA. Let's look closely at the impact.

Whatever the merit of the larger policy goal, § 162(m)(6) has had the effect of driving up compensation expenses at for-profit health insurance providers on their most valuable employees, namely physicians and senior management.

This paper intends to provide you with a brief tutorial on the workings of § 162(m)(6). Equally important, we lay out two solutions to help for-profit health insurance providers and their affiliates mitigate the impact of § 162(m)(6) without compromising their ability to attract and retain highly compensated, vital talent.

Inside Section 162(m)(6)

Section 162(m)(6) aims to prevent taxable insurance companies and their taxable affiliates from increasing executive compensation, made possible by the increased premium revenues earned from mandatory coverage sold through state and federal exchanges. This section was enacted to raise revenue to help pay for the ACA, like the fees charged to annual health insurers, medical device manufacturers, and brand-name prescription drug manufacturers.

[1]2018 Kaiser Family Foundation Survey

As mentioned earlier, § 162(m)(6) imposes a deduction limitation of $500,000 on a “covered health insurance provider” for “applicable individual remuneration” and “deferred deduction remuneration” attributable to services performed by an “applicable individual.” These terms demand an explanation.

Let’s first define *insurance provider or service provider:* “an individual who is an officer, director, or employee who provides service for, or on behalf of, the covered health insurance provider or any member of its aggregated group.” (1)

It is also essential to mention Section 4960, enacted as part of the Tax Cuts and Job Care Act of 2017. This enactment limits executive compensation for tax-exempt organizations to five highly compensated individuals; **§ 162(m)(6) applies to all employees who receive more than $500,000 of compensation.**

Take a moment to consider the national average (permanent) salary per doctor specialties, which can range from as low as $191,735 for pediatric infectious diseases to as high $662,755 for a neurosurgery, according to a 2019 Medscape Report. Each doctor’s healthcare employer faces costly penalties under § 162(m)(6).

Add to this, if you are a physician or medical professional also working temporarily in another practice, not your own, but the employers are connected, for example, through common ownership, you can earn 30 – 50 percent more than in a permanent position. In this scenario, the neurosurgeon’s second salary rises to $809,581.

We should note that independent contractors are subject to the deduction limitation of §162(m)(6) if they do not provide substantial services to other organizations. You could cause certain providers such as physicians to form separate professional corporations that contract with a for-profit professional corporation. **But that would not be regarded as a workable solution**. (2)

The term *Applicable Individual Remuneration* is the amount treated by wages to the executives employed by the corporation and any professionals employed by a professional corporation. Discretionary bonuses are paid in the year approved because they are included in wages for that year (3). Thus, incentive compensation payable to executives and any short or long-term bonus opportunity is subject to the $500,000 deduction cap in the year received, as are discretionary bonuses owed to the same individuals.

However, remuneration (subject to the deduction cap) excludes amounts contributed to qualified retirement plans such as 401(k) plans. (4)

Now it is time to understand *Deferred Deduction Remuneration*. By including it as part of § 162(m)(6), Congress anticipated an action commonly taken to lower taxable compensation for highly compensated individuals. Nonqualified deferred compensation plans (NQDC) allow highly compensated employees to defer salary and bonus until receipt at a future date. The deferred deduction remuneration provision does not prevent a health insurance provider and its taxable affiliates from offering an NQDC plan. However, **any compensation deferred by the executive still counts towards the annual calculation of § 162(m)(6) impact.** (5)

Tax Treatment of Hybrid Compensation

Section 162(m)(6) targets the traditional for-profit health insurance providers that comprise a large portion of the companies providing health insurance to the consumer marketplace and non-profit healthcare organizations. The non-profits provide health insurance (often HMO plans) and have affiliations with for-profit entities such as physician groups. Here is an example of such a situation:

> On December 4, 2017, the Internal Revenue Service (IRS) issued Chief Counsel Advice ("CCA") 201752008. In the CCA, a tax-exempt hospital and a taxable health insurer were part of an affiliated group within the meaning of § 414(b). If employed by the taxable insurer from January 1 through July 31 of the tax year, the employee is subject to § 162(m)(6)'s $500,000 deduction limit. The tax-exempt hospital compensates the same individual for the remainder of the tax year (August 1 through December 31).
>
> The IRS decided to aggregate compensation paid by the tax-exempt hospital and the taxable insurance company to determine the application of the $500,000 cap. This decision applies even if the tax-exempt hospital derives no tax benefit from a deduction for its share of the compensation paid to the employee.
>
> The employee received $750,000 from the taxable insurer and $250,000 from the tax-exempt hospital. Thus, the aggregate compensation exceeded $500,000 for the tax year and the deduction limit was allocated ($500,000 x ($750,000 / $1,000,000) = $375,000). Therefore, **the deduction limitation for the taxable insurer was not $500,000 but rather $375,000, so the excess $375,000 paid by the health insurer was not deductible.**

	(1)	(2)	(3)	(3) x ((1)/$1M)
	Source			
	Taxable Insurer	Tax-Exempt Hospital	Cap	Tax Deduction Limitation
Employee	$750,000	$250,000	$500,000	$375,000

Tax-exempt, provider-sponsored health maintenance organizations (HMOs) with taxable affiliates that employ highly compensated individuals were not the primary target of § 162(m)(6). However, industry trends suggest the number of organizations impacted may continue to grow given these developments:

- A growing desire for tax-exempt health systems to spin-off profitable lines of business, which can attract private equity, venture capital, or a potential IPO launch.
- The "Corporate Practice of Medicine" prohibition in several states, including California, Illinois, and Texas, has spurred non-profits to establish physician divisions or use professional corporations (aka the "friendly physician model") with many highly compensated physicians and senior managers.
- Many health systems have formed risk-bearing entities licensed as full-service or limited-purpose HMOs to insure the risks of third parties.

Potential Solutions—SERPs and Split-Dollar

Any solution to the challenges of § 162(m)(6) described above must involve the highly paid employee/independent contractor who voluntarily foregoes future increases or agrees to salary reductions to remain below the $500,000 deduction limit.

Unfortunately, the typical solution of implementing a traditional NQDC plan does not help solve the problem. What could entice an individual to lower their compensation? One possibility—offer the employee a benefit with the potential to gain significant future value such as at retirement, termination of employment, or premature death.

Two benefit structures that provide these features while reducing levels of non-deductible compensation are Supplemental Executive Retirement Plans (SERPs) and a Split-Dollar Life Insurance Loan Arrangement.[2]

Let's examine these potential solutions. First, we should mention that you can be assured, the two solutions presented in this brief paper have been used extensively in the marketplace over many decades and appropriately vetted by both advisors and regulators.

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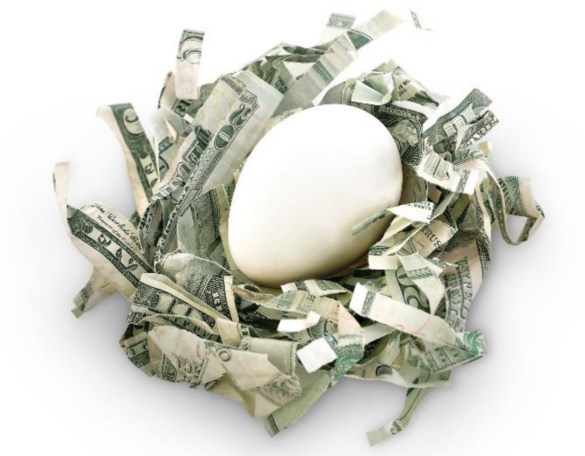
[2]Note: Any reduction in compensation would have to comply with constructive receipt rules.

Supplemental Executive Retirement Plan (SERP)

A SERP is a deferred compensation agreement between a company and the key executive. The company agrees to provide future supplemental retirement income based on the executive meeting specific, pre-agreed eligibility, and vesting conditions. [2]Note: Any reduction in compensation would have to comply with constructive receipt rules.



The company can fund the SERP out of cash flows, investment funds, or cash value life insurance. In the future, when paid, the benefits become taxable to the executive as income and tax deductible to the company.

In common usage, SERPs provide a retention and retirement program for highly compensated executives and valuable employees. As with an NQDC, a SERP is not subject to the discrimination testing rules of qualified retirement plans. Hence, plan participants can create substantial supplemental retirement benefits.

A tradeoff exists, however. The company must offer a discriminatory plan for a highly compensated employee, and the plan participant must be subject to the claims of an employer's general creditors in the event of a bankruptcy.

Split-Dollar Life Insurance Loan Arrangements

Regulation § 1.7872-15 governs split-dollar loans, treated as genuine loans for federal income tax purposes. This treatment differs from split-dollar arrangements defined in § 1.61-22(b). Therefore, as with § 4960, such loans should not be considered remuneration for purposes of § 162(m)(6) and regulation § 162-31(d)(8).

How does a split-dollar loan arrangement work? (Also known as loan regime split dollar)

- The participant, most likely an executive, places and owns a life insurance policy contract(s)

- As a loan, the contract requires the employer to pay the annual premium:
  - Repaid from contract cash value at employment termination or as death benefit
  - Employer retains a security interest in policy contract until repayment
  - On full payment, the participant owns all rights and interests in the policy

- Benefit to participant:
  - Growth of policy cash value over the cumulative loan-balance amount
  - Life insurance coverage typically in excess of the amount provided under an after-tax plan arrangement

- Taxation to the participant:
  - Annual imputed income based on "Applicable Federal Rate" (AFR) in effect each year. Long-term low at 1.12% in 2020 and 3% low for past several years
  - Taxable compensation, if any portion of loan balance forgiven
  - Cash value grows on a tax-deferred basis
  - Withdrawals are non-taxable (if properly structured)

- Allows the employer to carry the ongoing plan premiums as an asset, with most plan premiums recovered upon participant termination.

Scan the chart on the next page to learn the flow of Loan Regime Split Dollar, then compare key characteristics of the SERP versus the Loan Regime Split-Dollar solution:

COMPARISON OF KEY CHARACTERISTICS

Defined Contribution SERP vs. Loan Regime Split-Dollar

Key Characteristic	Defined Contribution SERP	Loan Regime Split-Dollar Arrangement
• *Nature of participant benefit*	• *Lump-sum payment of account balance or paid out over designated number of years upon vesting*	• *Potentially tax-fee supplemental retirement income if contract properly structured* • *With flexibility on timing and amount of withdrawals* • *Permanent life insurance coverage*
• *Taxation of benefits to participant*	• *Benefit taxable to participant at ordinary income tax rates upon vesting*	• *Annual taxable imputed interest on premium loans at the AFR* • *No taxation at the time of termination of the S/D arrangement, as there is no transfer of an asset* • *Potentially tax-free supplemental retirement income (if contract properly structured), the timing of which is controllable by the Participant*
• *Ownership of funding assets*	• *Sponsoring organization (if Plan informally funded)*	• *Participant owns the underlying life insurance contract*
• *Risks to participant*	• *Risk of forfeiture (if participant voluntarily terminates employment before the specified vesting period)* • *Investment risk (if Plan offers notional investment choice)* • *Credit risk: Participant is an unsecured general creditor of the sponsoring organization*	• *Investment/policy performance risk (the risk that the policy cash value will not grow as fast as expected)* • *Interest rate risk (the higher the AFR, the greater the tax cost)*
• *Investment flexibility*	• *Plan designs vary. Possible to offer notional investment choice to the participant*	• *Allocation of policy cash value among investment options, including equity indexes with downside protection*
• *Life insurance benefit*	• *No*	• *Yes. However, loads and expenses of insurance contracts impact the investment returns, if coverage not needed*

COMPARISON OF KEY CHARACTERISTICS *CONTINUED*

Defined Contribution SERP vs. Loan Regime Split-Dollar

Key Characteristic	Defined Contribution SERP	Loan Regime Split-Dollar Arrangement
• *Retention characteristics*	• *Strong, as a participant could be at risk of forfeiture of some portion of the benefit any time before the vesting date*	• *No risk of forfeiture, but the value of the participant's benefit grows over time and may not be of significant value for several years*
• *Financial impact to sponsoring organization*	• *Compensation expense accrued annually* • *Balance sheet liability equal to aggregate account balances*	• *Compensation expense converted to a balance sheet asset – loans to participants* • *Opportunity cost of money on premium loans*
• *Other issues*		• *Proper structuring and management of policy loans critical to cost-effectiveness and tax compliance* • *Varying effectiveness for participants at different ages*

Validated Solutions

Regardless of its original intent, § 162(m)(6) challenges taxable health insurance companies in ways not applied to other for-profit organizations. To continue to grow and prosper into the future, taxable health insurance companies must recruit and retain talented executives and physicians. To compete for this talent, these companies often need to pay compensation above $500,000. **Using a properly structured SERP or a Split-Dollar Life Insurance arrangement gives the for-profit health company a tool to save substantial cost over the long-term.**

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If you wish further guidance on how best to implement the SERP or Split-Dollar solution for your company, consult expert advisors on the subject. In this way, you gain the confidence to proceed down the path most appropriate for your objectives and aligned with your goals.

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Footnotes

(1) Reg. § 1.162-31(b)(9)
(2) Reg. § 1.162-31(b)(7)(ii).
(3) Reg. § 1.162-31(b)(10).
(4) Reg. § 1.162-31(b)(9)(ii).
(5) Reg. § 1.162-31(e)(4)

EBS Executive Benefit Solutions

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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