March 23, 2011

Internal Revenue Service
CC:PA:LPD:RU (Notice 2011-02)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments Regarding Notice 2011-02

Dear Sir or Madam:

America's Health Insurance Plans ("AHIP") and the American Benefits Council ("Council") respectfully submit this letter in response to the request by the Internal Revenue Service ("Service") for comments in connection with the application of section 162(m)(6) of the Internal Revenue Code of 1986, as amended ("Code"),[1] generally and in connection with specific issues raised in Notice 2011-02 ("Notice"). We thank the Service for its efforts to provide timely guidance on section 162(m)(6) and for its interest in learning about public concerns via its request for comments.

AHIP is the national association representing approximately 1,300 health insurance plans that provide coverage to more than 200 million Americans. AHIP's members offer a broad range of health insurance products in the commercial marketplace and have demonstrated a strong commitment to participation in public programs.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The potential tax consequences – and administrative burdens – of being subject to the new deduction limit established by section 162(m)(6) could be substantial. However, the imprecise language of section 162(m)(6) leaves some critical issues unresolved regarding the application of the deduction limit. Section 162(m)(6)(H) specifically provides regulators with the authority to issue guidance, rules, or regulations to carry out the purposes of the new law. The Notice addresses a number of the time-sensitive issues under section 162(m)(6), but a need for additional guidance remains.

[1] Unless otherwise indicated, section references hereinafter are to the Code.

COMMENTS ON ITEMS ADDRESSED GENERALLY IN NOTICE 2011-02

EFFECTIVE DATE

The Notice correctly confirms that the section 162(m)(6) deduction limit applies to deferred compensation attributable to services performed in 2010, 2011, or 2012 (for a calendar-year taxpayer)[2] only if: (1) the employer was a covered health insurance provider ("CHIP") in the year the services were performed to which the deferred compensation is related; and (2) the employer is a CHIP in the year such deferred compensation is paid.

The Notice added substantial clarity with regard to the effective date of section 162(m)(6), although some ambiguity remains. We agree with the Service's conclusion. There are no policy grounds for applying section 162(m)(6) to a broader swath of taxpayers for the 2010-2012 period than would be subject to the rules when the deduction limit goes into effect in 2013. Given the anti-abuse aspect of the provision, it is correct to view section 162(m)(6) as aimed at taxpayers that are covered health insurers and that expect to be subject to the deduction limit when it first begins to apply in 2013 (*e.g.*, a taxpayer that is a CHIP after 2012 would be prevented from converting an amount that would be otherwise be paid as current compensation in 2013 or later into deferred compensation that is fully vested and granted prior to January 1, 2013).

The legislative history of section 162(m)(6) supports this approach. What became section 162(m)(6) was initially proposed as an amendment by Senator Blanche Lincoln (D-AR) during the Finance Committee's mark-up of the legislation that became the Patient Protection and Affordable Care Act ("PPACA"). Significantly, in discussing the objectives of the provision, Senator Lincoln explained her intent of applying the new deduction limit to health insurance companies that would benefit from the expanded coverage under health insurance reform, *i.e.*, those insurers that provide the "minimum essential coverage" mandated by the PPACA rather than those who issue little to no minimum essential coverage.[3]

Requested Guidance: In addition to the clarification already made, we request that the Service provide guidance that the deduction limit does not apply to the 2010-2012 period if the taxpayer is not a CHIP in 2013 (regardless of whether it becomes a CHIP in a subsequent year). This would significantly ease the burden on taxpayers in having to maintain records relating to 2010, 2011, and 2012. Without this clarification, taxpayers who received even very modest health insurance premiums in 2010–2012 may be required to track all deferred compensation in excess of $500,000 from 2010-2012 until it has been fully paid. In the case of a supplemental employee retirement plan (SERP) and many other types of deferred compensation plans, this could require that very small incremental benefits be tracked for the remainder of the individual's career and then accounted for as payments are made over his or her lifetime – a significant administrative

[2] Although the statute is based on taxable years, we will hereinafter simplify the discussion (at least somewhat) by assuming a calendar-year taxpayer.

[3] "When health insurance reform becomes law, health insurance companies will receive millions of new customers purchasing their product for the first time. My amendment is intended to encourage those insurance companies to put the additional premium dollars they will be bringing in with the volume of new customers back toward lowering their rates . . . ." 155 CONG. REC. S12,540 (Dec. 6, 2009) (statement of Sen. Lincoln).

burden relative to the small amounts that would be tracked and distributed. An entity that is not a CHIP in 2013 or, at a minimum, an entity that is not a CHIP for a brief period of time after 2013 (e.g., 2 years) should not be required track deferred compensation earned in 2010-2012 indefinitely on the off chance that it would become a CHIP at some later date.

DE MINIMIS RULE

The Notice states that an entity will not be a CHIP in 2010, 2011, or 2012 if the premiums it receives from "health insurance" are less than 2% of gross revenues for the year in question. It further provides that, for years after 2012, an entity will not be a CHIP if the premiums it receives from health insurance that is "minimum essential coverage" are less than 2% of gross revenues. In addition, the Notice says that the broad controlled group rule applies for purposes of section 162(m)(6) and an example confirms that the de minimis rule is also applied on a controlled group basis.

We agree with the Service that a de minimis rule of 2% of gross revenues strikes an appropriate balance. In the absence of a de minimis rule such as the one provided in the Notice, it would have been possible to read section 162(m)(6) to subject an entire controlled group of companies to the limitation even though the entity receives relatively little revenue from health insurance premiums. This would have raised a series of anomalous results for employers that are clearly not in the health insurance business in any material way. On the other hand, it is important that the de minimis rule remain just that – de minimis, so as not to provide competitive advantage to companies that have a material amount of health insurance business. As indicated, the 2% of revenue rule suggested in the Notice strikes an appropriate balance in our view.

DEFINITION OF APPLICABLE INDIVIDUAL

Section 162(m)(6) only applies to remuneration paid to "applicable individuals," including individuals who are service providers to a CHIP. The Notice provides that the term "applicable individual" does not include an independent contractor with respect to whom a compensation arrangement would not be subject to section 409A (generally excepting arrangements with independent contractors providing substantial services to multiple unrelated customers).

Requested Guidance: We support the guidance provided in the Notice and additionally request that the Service provide guidance regarding simplified safe harbor mechanisms for obtaining confirmation from individuals that they are independent contractors that fit within the safe harbor provided in the regulations under section 409A. For example, we urge the Service to provide a safe harbor permitting entities to rely on individuals' self-certifications of independent contractor status in the absence of any reason to question the authenticity of the self-certifications.

DEFINITION OF INSURANCE: TREATMENT OF REINSURANCE

The Notice provides that, in determining whether a taxpayer is a CHIP, premiums received under an indemnity reinsurance contract are not treated as premiums from providing health insurance coverage.

Requested Guidance: We support the guidance on reinsurance that is provided in the Notice. The guidance provided in the Notice makes good policy and practical sense because, in a reinsurance arrangement, the reinsurer is not providing *health* insurance; rather, the reinsurance is intended to limit the issuer of record's financial exposure. Even where the underlying risk subject to the reinsurance is health insurance coverage provided by an original insurer, the reinsurer is not providing "benefits consisting of medical care" as that term is used in section 9832(b)(1)(A), since the contractual arrangement is between the two insurers in the case of reinsurance. Accordingly, premiums received from typical reinsurance are not premiums from providing health insurance coverage for purposes of section 162(m)(6). This interpretation is in sync with prior interpretations of similar statutory language by courts and agencies.[4]

EFFECTIVE DATE OF NOTICE 2011-02

The Notice is effective beginning in 2010. The Notice states that the Service anticipates including the guidance provided by Notice 2011-02 in upcoming regulations but if any changes are made that would expand the reach of section 162(m)(6), those changes would be made prospectively.

Requested Guidance: We support the effective date provided in the Notice but urge that further guidance provide that deferred compensation issued before 2010 (*e.g.*, stock option grants) should be excepted from the section 162(m)(6) deduction limit, even where not fully vested as of January 1, 2010. There is no indication that Congress intended that such an inequitable retroactive change in taxation was intended.

COMMENTS ON ITEMS WHERE THE SERVICE REQUESTS SPECIFIC COMMENT

APPLICATION OF THE CHIP DEFINITION IN MERGERS, ACQUISITIONS, OR REORGANIZATIONS

The application of the CHIP rules in the context of mergers, acquisitions, and reorganizations could be extremely complex and challenging. As a result, a number of issues need to be addressed through guidance, including the following:

- What would be the treatment of deferred deduction remuneration where a CHIP is acquired and thus ceases to be a CHIP?
- If a CHIP acquires or merges with a non-CHIP entity, what would be the treatment of deferred compensation earned by the employee for services with the non-CHIP entity, but

[4] *See, e.g.*, 45 C.F.R. § 160.103 (defining "health plan" to mean "an individual or group plan that provides, or pays the cost of, medical care (as defined in section 2791(a)(2) of the Public Health Service Act ("PHSA"), 42 U.S.C. § 300gg-91(a)(2))"); Patient Safety and Quality Improvement, 73 Fed. Reg. 70,732 (Nov. 21, 2008) (construing the term "health insurance issuer" as defined in section 2971 of the PHSA, the mirror provision to section 9832(b)(2), to not include "reinsurers"); ERISA Adv. Op. 82-11 (stating that the indemnity reinsurance arrangement at issue "is not a contract for life insurance, health insurance, or annuities but merely the assumption of risk by another company"); *Sec. Ins. Co., Inc. v. North River Ins. Co.,* 4 F.3d 1049 (2d Cir. 1993) ("The reinsurer is not directly liable to the original insured. Reinsurance involves contracts of indemnity, not liability. Reinsurers do not examine risks, receive notice of loss from the original insured, or investigate claims. In practice, the reinsurer has no contact with the insured.").

ultimately paid after the controlled group becomes subject to the rule because of the inclusion of the CHIP?

- How would mid-year transactions be treated?

Requested Guidance: In the event of a merger or acquisition that changes the status of the entity from a CHIP to a non-CHIP or vice versa, remuneration to an individual should only be subject to the section 162(m)(6) deduction limit if the compensation was (1) earned for services performed in a year that the employer was a CHIP, and (2) paid in a year that the employer was a CHIP. This rule, which is consistent with the approach the Service adopted with respect to the effective date for the 2010-2012 years, would create an administrable rule in the case of mergers, acquisitions, and reorganizations.

It is clear under the statute that remuneration earned by an individual for services performed for an entity that is not a CHIP will never be subject to the section 162(m)(6) deduction limit even if the remuneration for those services is deferred until a year when the employer becomes a CHIP. Section 162(m)(6)(A)(ii), in relevant part, provides that no deduction will be allowed (in excess of $500,000) for "deferred deduction remuneration . . . which is attributable to services performed by an individual during any disqualified taxable year" (emphasis added). Section 162(m)(6)(B) states that "disqualified taxable year" (hereinafter a "DTY") "means, with respect to any employer, any taxable year for which such employer is a covered health insurance provider." Thus, deferred deduction remuneration must be attributable to services performed during a DTY and a DTY is a year for which such employer is a CHIP. If the employer is not a CHIP in the year the services are performed, the deferred deduction remuneration for those services will not be subject to the section 162(m)(6) deduction limits even if the employer (or the employer's controlled group) becomes a CHIP. While the statutory language is at best ambiguous on this point, there is no indication that Congress intended that entities that were not CHIPs should ever lose the benefit of an ordinary and necessary business deduction. To the contrary, as discussed above, the congressional proponents of section 162(m)(6) intended the provision to apply only to those health insurers who ostensibly would be the beneficiaries of the expanded insurance coverage contemplated under the PPACA.

Requested Guidance: In the case of a merger, acquisition, or reorganization, we request that, in the case of a mid-year merger or acquisition, guidance clarify that the CHIP status of all entities would be determined for the calendar year at the end of such calendar year. Thus, even if an individual was paid remuneration (including deferred compensation) from an employer that was a CHIP during the first six months of the year (prior to the merger or acquisition), compensation would not be subject to the section 162(m)(6) limit if the new combined entity was not a CHIP based on the application of the definition as of the end of the year.

Requested Guidance: Consistent with the interpretation above, we further suggest that future guidance include clarification that the position reflected in the Notice with respect to the 2010-2012 years be made the permanent rule with respect to all years in all cases (*i.e.*, whether or not there is a merger or acquisition involved). Thus, such guidance would provide that the section 162(m)(6) deduction limit would only apply with respect to deferred compensation if the employer is a CHIP both in the year the services were performed (even if such year is after 2012) and in the year the deferred compensation is paid. As noted, the statutory language is convoluted

and is at best ambiguous on this point, but this interpretation of the provision is consistent with the expressed intent of Congress.[5]

ALLOCATION OF DEFERRED COMPENSATION TO AN APPROPRIATE YEAR

The Notice requests comment regarding whether rules similar to Notice 2008-94, Q&A-9 (dealing with remuneration by TARP recipients in connection with section 162(m)(5)) should be applied for purposes of allocating deferred compensation to a particular year. As the Service is aware, the rules set forth in the Notice for allocating deferred compensation are very complex and costly to administer, especially with respect to allocating earnings. Moreover, the policy considerations that may have motivated the rules set forth in the Notice (specifically, that a TARP recipient should not be able to avoid application of the deduction limitation by deferring the payment of compensation to a year in which it is no longer subject to section 162(m)(5)) are not present here with regard to CHIPs. Accordingly, we request the guidance set forth below.

Requested Guidance: For purposes of allocating earnings accrued on deferred compensation to a particular year, a CHIP should be permitted to use the rules set forth in Notice 2008-94, or any other reasonable method including the following safe harbor methods:

- *With respect to a given plan or arrangement, earnings could be allocated to the year in which it is accrued.* Under this method, a CHIP would allocate earnings to the year in which it is accrued and would not be required to relate the earnings back to the year in which the underlying deferred compensation was earned. For example, assume an "applicable individual" accrues $100 of vested deferred compensation in each of four consecutive years beginning on January 1, 2011, and that all deferred compensation is payable at the close of the four-year period on December 31, 2014. Assume further that earnings attributable to such deferred compensation is accrued in amounts equal to $8 in 2011, $20 in 2012, $32 in 2013 and $40 in 2014, and that the related employer became a CHIP in 2010 and remains a CHIP for all years thereafter. Under this proposed method, rather than having to allocate some portion of each year's earnings to the year in which the underlying deferred compensation was earned (*e.g.*, some portion of the $40 of earnings accrued in 2014 would need to be allocated to 2011, 2012, 2013 and 2014), as would be the case under Notice 2008-94, a CHIP would allocate the earnings to the year in which it is accrued, *i.e.*, $8 in 2011, $20 in 2012, $32 in 2013 and $40 in 2014.

- *With respect to a given plan or arrangement, all earnings could be allocated to the year the first dollar of deferred compensation (or earnings thereon) is paid to the applicable individual.* Under this method, with respect to a given plan or arrangement, a CHIP could elect to allocate all accrued earnings to the year when the first dollar of deferred compensation (or earnings thereon) is paid to the "applicable individual." Using the example set forth above, the CHIP would be permitted to allocate all $100 of accrued

[5] We would note that the policies underlying the section 162(m)(6) provisions are significantly different from those that govern the 162(m)(5) rules for participants in the Troubled Asset Relief Program ("TARP"). In the case of TARP recipients, the expectation was that entities receiving relief in the form of government funds would ultimately exit the program, *i.e.*, it was a temporary program. In the case of section 162(m)(6), the statutory rules are permanent and the expectation is that most entities that are CHIPs will remain so.

earnings ($8 in 2011 + $20 in 2012 + $32 in 2013 + $40 in 2014 = $100) to 2014, the year when such earnings are paid.

- *With respect to a given plan or arrangement, all earnings could be allocated to the first year of the "earning period."* Under this method, all earnings attributable to deferred compensation earned by an applicable individual over the course of the "earning period" would be allocated to the first year of such "earning period." For this purpose, the "earning period" means the period (i) beginning on the later of (a) the first year an entity is a CHIP, or (b) the year the first dollar of underlying deferred compensation is earned by the applicable individual with respect to a given plan or arrangement, and (ii) ending on the close of the year in which the first dollar of such deferred compensation (or earnings thereon) is paid to the applicable individual. Thus, in our example above, the CHIP would allocate all $100 of earnings to 2011, the first year of the earning period.

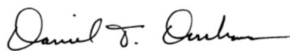
- *With respect to a given plan or arrangement, all earnings could be allocated ratably over the earning period.* Under this method, with respect to a given plan or arrangement, a CHIP would allocate ratably any earnings that accrues over the course of the earning period. Using our example from above, the CHIP would allocate $25 to 2011, $25 to 2012, $25 to 2013, and $25 to 2014.

In any event, given the variety and complexity of compensation arrangements (including in particular defined benefit SERPS), and regardless of the number of safe harbors provided, guidance should provide that any reasonable method for allocating earnings would be permitted.

* * *

Thank you for your consideration of these matters. Again, we are very appreciative of the Service's hard work in this important new area of the law. Please let us know if we can provide any assistance as you move forward in developing the regulatory framework under section 162(m)(6).

Sincerely,



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