NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS

UNDER SECTION 162(M)(6)

September 9, 2013

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* An index of defined terms used herein is attached for reference at the conclusion of this report.

New York State Bar Association Tax Section

Report on Proposed Regulations Under Section 162(m)(6)

I. Introduction

This report[1] sets forth our comments on Proposed Treasury Regulations Section 1.162-31 (the "Proposed Regulations")[2] under Section 162(m)(6) of the Internal Revenue Code of 1986, as amended (the "Code").[3] Code Section 162(m)(6), enacted as section 9014 of the Patient Protection and Affordable Care Act of 2010 ("PPACA"),[4] limits the deduction allowed for compensation paid to individuals for services provided to certain health insurance companies. The Proposed Regulations, released on April 2, 2013, generally affirm and expand on interim guidance previously provided by Notice 2011-2, released on December 23, 2010.[5]

We commend the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") on the Proposed Regulations. Section 162(m)(6) is, in many respects, a difficult provision to implement, and the Proposed Regulations are comprehensive, clear, workable and administrable. Our recommendations are in the nature of fine-tuning.

Section 162(m)(6) caps at $500,000 per year the deduction allowed for remuneration paid to individuals ("Applicable Individuals") who provide services to "covered health insurance providers" ("CHIPs"). For taxable years beginning after December 31, 2012, a CHIP is a health insurance issuer at least 25% of the income of which from health insurance premiums in each year derives from providing "minimum

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[2] See Notice of Proposed Rulemaking (REG-106796-12) 78 Fed. Reg. 19,950 (April 2, 2013). There exists another Proposed Treasury Regulations Section 1.162-31, regarding the deductibility of "local lodging expenses" (i.e., lodging expenses paid or incurred while not traveling away from home). See Notice of Proposed Rulemaking (REG–137589–07) 77 Fed. Reg. 24,657 (Apr. 25, 2012). In this report, all references to "Prop. Treas. Reg. § 1.162-31" are to the April 12, 2013 proposal. An index of the defined terms used in this report is included at the end.

[3] Unless otherwise indicated, all "Section" references are to the Code.

[4] Pub. L. No. 11-148, 124 Stat. 119, 868 (2010).

[5] Notice 2011-2, 2011-2 I.R.B. 260 (Dec. 23, 2010).

essential coverage" under PPACA (that is, the sale of health insurance to satisfy the insureds' obligation to comply with the so-called "individual mandate" imposed by PPACA). The statute also contains an aggregation rule (the "CHIP Aggregation Rule") providing generally that, if any member of a controlled group under certain provisions of Section 414 (collectively, an "Aggregated Group") is a CHIP, then every other member of the controlled group is likewise treated as a CHIP.

Unlike previously enacted limitations under Section 162(m), the limitation under Section 162(m)(6) applies to compensation paid to all individual service providers, rather than just to certain senior executives, and there is no exception for commissions or "performance-based" compensation. The expansive nature of Section 162(m)(6) makes it particularly important, in our view, that the final regulations not extend the provision to employers or service providers that are not required to be covered by the terms of the statute.

In addition, unlike most similar provisions of the Code (including Section 162(m) generally), the annual Section 162(m)(6) limitation is based on the year in which the compensation is earned, not when it is paid or otherwise deductible. With respect to any year, the $500,000 limit applies not only to compensation ordinarily deductible in that year, but also to deferred compensation "attributable to services performed" in that year that would otherwise be deductible in a later year (in which case, the later deduction may be reduced or denied).

The Proposed Regulations generally follow the prior guidance set out in Notice 2011-2, and further elaborate on and provide a number of exceptions to the underlying statutory provisions. They contain, among other things, extensive and detailed rules for attributing deferred compensation to particular service years, definitions further clarifying the potential entities that will be treated as CHIPs for particular years and various transitional and grandfathering rules. This report sets out recommendations and suggestions as to how the Proposed Regulations might be improved.

II. Summary of Recommendations

As discussed further in Part IV, our recommendations are:

1. If members of an acquiror group become CHIPs solely as a result of the group's acquisition of a CHIP, we recommend that those acquiror group members not be treated as CHIPs until their first taxable year beginning at least six months after the closing date of the acquisition transaction (rather than in the next taxable year in all cases, as under the Proposed Regulations).

2. We recommend that final regulations clarify that if an Aggregated Group disposes of a CHIP during a taxable year, the de minimis rule in the Proposed Regulations will be applied to the Aggregated Group for the year of the disposition taking into account the revenues earned by the transferred member only during the time it was a member of the Aggregated Group (even if that transferred member's taxable year does not close on the date it departs the group).

3. When an Aggregated Group that has designated a member as the "parent" entity for purposes of the Proposed Regulations disposes of that member,we recommend that, if there remains another CHIP in the Aggregated Group with the same taxable year as the old parent, that CHIP should be required to become the new designated parent. And that, in all other cases, the Aggregated Group be permitted to designate any remaining CHIP as the parent, with a short transitional testing year before the new designee's full testing year begins.

4. In a response to a request for comments on how to ensure that Section 162(m)(6) applies to remuneration paid for services in substance rendered directly by individuals (rather than entities), we recommend that when a CHIP reports remuneration payments on a Form 1099 or W-2 issued directly to a natural person, that natural person be considered the service provider for purposes of Section 162(m)(6); and that, when a CHIP reports remuneration as being paid to a service provider entity, and that reporting is not found to be incorrect (under Section 6041), the entity be respected as the service provider for Section 162(m)(6) purposes.

5. With respect to the attribution of DDR to taxable years, we make the following recommendations:

    a. We recommend that the final regulations allow CHIPs that select the so-called "standard method" of the Proposed Regulations to attribute amounts in account balance plans to taxable years be permitted to use the Proposed Regulations' "alternative method" to attribute amounts grandfathered from before 2010 (instead of being required to use the same method for both nongrandfathered and grandfathered amounts).

    b. We suggest an alternative method (to be included in the final regulations) for attributing payments under nonaccount balance plans to service years, under which each benefit payment is attributed to taxable years (including grandfathered pre-2010 years) in proportion to the increase in the formula benefit during the taxable year.

    c. We recommend that the final regulations make optional, rather than mandatory, the multistep reattribution method requiring daily pro rata attribution over the applicable vesting period of account balance plans, nonaccount balance plans, and other legally binding rights subject to a substantial risk of forfeiture, and that CHIPs be allowed to determine plan-by-plan whether to apply this method.

    d. We suggest that, instead of attributing equity-based remuneration in daily pro rata portions from the date of grant to the date of vesting, exercise or payment, CHIPs have the option to attribute equity compensation entirely to the taxable year in which the equity-based compensation vests, is exercised, or is includible in income.

    e. Where stock rights or RSUs vest on an acquisition or similar transaction, we recommend that CHIPs be permitted to use a reattribution rule (similar to that

applicable to account balance and nonaccount balance plans) to attribute pre-transaction appreciation in those stock rights and RSUs to the pre-vesting period or, as suggested immediately above, to attribute such appreciation entirely to the year of vesting.

f. We suggest that final regulations clarify that the grandfathering rule applies to all forms of DDR (not only account balance plans, nonaccount balance plans and equity-based remuneration) and that, in the case of each form of DDR, grandfathered amounts should be attributed based on the attribution rules generally applicable to that form of DDR, but disregarding any substantial risk of forfeiture.

III. Background

A. Prior Limits on Deductibility: Sections 162(m) and 162(m)(5)

Prior to 1984, compensation deductions were limited by the general "reasonable compensation" rule of Section 162(a)(1).[6] As a practical matter, however, this rule is generally used to disallow or recharacterize compensation deductions where the employer and service provider are related or otherwise trying to disguise nondeductible payments as compensation (for example, a portion of an unreasonably large salary payment made to a corporation's employee-shareholder might instead be recast as a dividend).[7]

With Section 162(m), passed in 1993, Congress placed a fixed cap on the deductibility of compensation paid to certain executives of public companies. Under Section 162(m), a public corporation generally cannot deduct more than $1 million of annual compensation paid to each of its "covered employees"—the corporation's chief executive officer and each of its three most highly compensated other employees (other than the CEO and chief financial officer).[8]

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[6] Section 162(a)(1) permits a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." See also Treas. Reg. § 1.162-7(a) ("The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.")

[7] E.g., Treas. Reg. § 1.162-7(b)(1) (employee-shareholder example). S*ee generally* Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 22.2 (stating that disallowance under Section 162(a)(1) "almost never" occurs " unless the employer and employee are related or engage simultaneously in another transaction . . . where a purported payment for services may be in whole or part a disguised gift, loan, dividend, or payment for property").

[8] Under the statute, "covered employee" is defined as the CEO and the employees whose compensation "is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year", Section 162(m)(3)(B), a definition which mirrored the list of "named executive officers" whose compensation had to be disclosed under the then-extant version of Item 402 of Regulation S-K, 17 C.F.R. § 229.402 (1993). In 2006, however, the Securities and Exchange Commission amended Item 402 to alter the list of named executive officers to the CEO, the CFO and the three most highly compensated executive

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Although Section 162(m)(4) defines the compensation subject to the $1 million cap broadly, it also contains a number of important exceptions. In particular, "performance-based compensation" (including nondiscounted stock options) and remuneration paid on a commission basis are excluded from the calculation of the $1 million limitation.[9]

In addition, the cap on deductibility only applies in years in which the recipient is a covered employee. Compensation deferred until after the executive's retirement or termination of employment, therefore, generally remains fully deductible.

In 2008, as part of the Emergency Economic Stabilization Act of 2008 ("EESA"),[10] Congress enacted Section 162(m)(5), a further restriction on the deductibility of executive compensation paid by participants in the troubled assets relief program ("TARP") established by EESA. Under Section 162(m)(5), the deduction for compensation paid by certain TARP participants ("applicable employers") to their CEO, CFO and next three most highly compensated employees ("covered executives") for services in an "applicable taxable year"[11] was capped at $500,000 a year. Unlike the base rule of Section 162(m) discussed above, Section 162(m)(5) applies to private as well as public companies, and to partnerships and other non-corporate forms of business as well as corporations. Section 162(m)(5) applies the aggregation rules of Section 414(b) and (c) in determining whether an employer is a covered employer (the "TARP Aggregation Rule").[12]

Section 162(m)(5) also expanded the class of compensation subject to the cap. It lacks the exceptions for commission- and performance-based compensation. It also limits the ability to avoid the cap through deferral: the $500,000 limit for an applicable

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officers (other than the CEO and CFO). Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,241 (Sept. 8, 2006) (revising 17 C.F.R. § 229.402(a)). The following year, the IRS announced that, because the disclosure rules had changed and the statute had not, only the CEO and the three next most highly compensated executive officers (other than the CEO and CFO) would be considered "covered employees"—excluding the CFO entirely, even if his or her compensation would otherwise have been required to be disclosed by reason of its amount. See Notice 2007-49, 2007-25 I.R.B. 1429 (Jun. 4, 2007).

[9] Section 162(m)(4)(C) and Treas. Reg. § 1.162-27(e) also impose a number of procedural requirements on performance-based compensation.

[10] Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008).

[11] An "applicable taxable year" is any taxable year during which the authorities for the TARP established under EESA are in effect (the "authorities period") if the aggregate amount of troubled assets acquired from the employer under that authority during the taxable year (when added to the aggregate amount so acquired for all preceding taxable years) exceeds $3,000,000,000. Section 162(m)(5)(C).

[12] In applying Section 414, only parent-child controlled groups are covered; the statute disregards the rules for brother-sister controlled groups and combined groups under Section 414(b) and (c) (by reference to Section 1563(a)(2) and (3)).

taxable year also includes "deferred deduction executive remuneration" for services performed in that applicable taxable year but for which the employer takes a deduction in later years. Any portion of the $500,000 limit that is unused after taking into account currently deductible compensation in an applicable taxable year is carried forward until the year in which the compensation is otherwise deductible, and the unused limit is applied to the deduction for the deferred compensation in that later year.[13]

The exception for deferred compensation paid after the termination of employment was also eliminated. Thus, once designated a covered executive, an employee remains a covered executive, even after termination of employment, until all deferred deduction executive remuneration attributable to services provided during an applicable year would otherwise be deductible. Deferred compensation that was earned for services provided during a year that is not an applicable year, however, is not covered by Section 162(m)(5) even if paid in an applicable year.

B. PPACA and Section 162(m)(6)

In 2010, Congress passed PPACA. Central to PPACA's overhaul of the nation's health insurance system was the individual mandate requiring most Americans to obtain a health insurance plan meeting the standard for "minimum essential coverage" set forth in Section 5000A(f) of the Code.[14] This individual mandate was seen by some as providing a potential financial windfall to health insurance companies, whose product most Americans would now be required to purchase. In this regard, citing the desire to ensure that this windfall would be used to provide better care and not be used to subsidize excessive executive salaries, Senator Blanche Lincoln introduced the provision that eventually became Section 162(m)(6).[15]

Structurally, Section 162(m)(5) and Section 162(m)(6) bear much in common:

- Just as Section 162(m)(5) lowered the deductibility cap to $500,000 for one set of employers (TARP recipients) seen as receiving a government subsidy, so Section 162(m)(6) lowers the compensation deductibility cap to $500,000 for another:

[13] The IRS later promulgated guidance on attributing deferred deduction executive compensation to prior periods. See Notice 2008-94, 2008-44 I.R.B. 1070, Sec. III.B, Q&A 9 (Oct. 14, 2008).

[14] Section 5000A; see also *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S.Ct. 2566 (2012) (upholding the penalty imposed under Section 5000A(b) as a tax on individuals who fail to maintain minimum essential coverage).

[15] See, e.g., 155 Cong. Rec. S.12,540 (statement of Sen. Lincoln) ("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 and making more affordable coverage for consumers, not putting it in their pocketbooks.").

health insurance companies seen as receiving a "subsidy" in the form of a legally compelled purchase of their product.[16]

- Like status as an "applicable employer" under Section 165(m)(5), an employer's status as a CHIP is determined on an annual basis. For taxable years beginning after 2012, a health insurance provider is a CHIP if at least 25% of the "gross premiums received from providing health insurance coverage" is from "minimal essential coverage" under Section 5000A(f).[17] Section 162(m)(6) likewise contains the broad CHIP Aggregation Rule, making the deduction limitation applicable to all members of an Aggregated Group that includes a CHIP.[18]

- As under Section 162(m)(5), Section 162(m)(6) applies to a broader range of compensation than Section 162(m) generally. Thus, there are no exceptions for commission- or performance-based compensation or compensation arrangements in place at the time of enactment.

- Section 162(m)(6)(A)(ii), like Section 162(m)(5), contains a similar "carry-forward" concept for deferred compensation. The $500,000 limit in any particular year applies not only to currently deductible "applicable individual remuneration" ("AIR"), but also to "deferred deduction remuneration" ("DDR") that is "attributable to services performed by" an Applicable Individual in any taxable year in which an employer is a CHIP.[19] Any portion of the limitation left unused after accounting for currently deductible compensation is carried forward until the

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[16] This purchase is, in the case of certain low-income individuals, itself publicly subsidized through a refundable tax credit under Section 36B.

[17] For taxable years 2010-2012, a CHIP is simply any health insurance issuer, as defined in Section 9832(b)(2) of the Code, that "receives premiums from providing health insurance coverage" as defined in Section 9832(b)(1). See Section 162(m)(6)(C)(i)(I). Thus, for 2010-2012, any insurer that issues traditional health insurance coverage is considered a CHIP. CHIPs will not lose any deductions in these earlier years, however; the deduction will only be lost for deferred compensation that is earned in 2010–2012 but is deferred into post-2013 periods when the employer is again a CHIP. A Section 9832(b)(2) covered health insurance provider is a company, service, or organization licensed as an insurer and subject to state insurance regulation within the meaning of Section 514(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

[18] In particular, Section 162(m)(6)(C)(ii) provides that all members of any controlled group of corporations (within the meaning of Section 414(b)), other businesses under common control (within the meaning of section 414(c)) and affiliated service groups (within the meaning of Section 414(m) and (o)) are treated as an Aggregated Group. Also, as under Section 162(m)(5), the CHIP Aggregation Rule does not extend the definition of Aggregated Group to brother-sister controlled groups and combined groups under Section 1563(a)(2) and (3).

[19] AIR is defined as the aggregate amount otherwise allowable as a deduction for a taxable year for remuneration for services performed by an Applicable Individual, but excludes any DDR with respect to services performed during that taxable year. § 162(m)(6)(D). DDR is defined as remuneration which would be AIR for services performed in a taxable year but for the fact that the deduction for such remuneration is allowable in a subsequent taxable year. § 162(m)(6)(E).

year in which the applicable year's DDR would otherwise be deductible and then applied to the DDR in determining whether the deduction is available in the later year.

Despite these similarities, Section 162(m)(6) also differs from prior caps on compensation deductions in important ways. Perhaps the most significant is that of scope. While both Section 162(m) generally and Section 162(m)(5) specifically capped only compensation paid to an employer's four or five top executives, Section 162(m)(6) applies to the remuneration of all of a CHIP's directors, officers, employees and other individual service providers (including independent contractors). Even before application of the CHIP Aggregation Rule, therefore, Section 162(m)(6) already has a much broader scope than those prior statutes.

The CHIP Aggregation Rule, however, multiplies this effect still more widely. In contrast to the TARP Aggregation Rule, which had the effect of narrowing the application of Section 162(m)(5) (since a parent-child controlled group will generally have only one set of CEO, CFO and highest-paid three other employees, regardless of how many entities in the group are TARP participants), the CHIP Aggregation Rule instead broadens the application of Section 162(m)(6). Under the statute, the presence of a single CHIP in a controlled group has the effect of turning every member of the entire Aggregated Group into a CHIP, thereby capping the deductibility of compensation paid to service providers by member entities whose activities and employees may have nothing to do with the provision of minimum necessary coverage, or with health insurance at all. Thus, the CHIP Aggregation Rule can have a dramatic effect on which employer entities are subject to Section 162(m)(6). A review of the legislative history suggests that this potential effect of the CHIP Aggregation Rule may not have been widely understood when the provision was enacted.[20]

The impact of Section 162(m)(6) is broader than that of Section 162(m)(5) in other ways as well. TARP, and the broader EESA of which it was a part, were designed to respond to some of the perceived excesses that led to the financial crisis, and Section

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[20] The legislative history, from the earliest descriptions of the amendment when it was offered by Senator Lincoln in the Senate Finance Committee, only describes the CHIP Aggregation Rule as applying "in determining whether the remuneration of an applicable individual for a year exceeds $500,000". S. Finance Comm., Amendments Related to Financing Comprehensive Health Care Reform 8 (Sept. 19, 2009), *available at* http://www.finance.senate.gov/legislation/download/?id=ebb3e23f-78da-481f-9ae7-62ea17935ad5 (accessed June 18, 2013); see also S. Rep. No. 111-89, at 355 (2009) (same, in Senate Finance Committee report for bill reported out of the Senate Finance Committee); Staff of the Joint Comm. on Taxation, 111th Cong., JCX-18-10, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act" 101 (2010), available at https://www.jct.gov/publications.html?func=startdown&id=3673 (accessed June 18, 2013) (same).

The foregoing suggests that the CHIP Aggregation Rule may have been intended as an anti-abuse rule, to prevent avoidance of the Section 162(m)(6) cap by having entities related to a CHIP pay the CHIP's service providers. Rather than applying the rule in defining the scope of AIR and DDR, however, the CHIP Aggregation Rule applies in defining what entities will themselves be considered CHIPs.

162(m)(5) was designed not to further underwrite or reward those excesses. Moreover, TARP was by its very nature intended to be a temporary emergency measure to respond to the financial crisis. Companies are expected to participate in TARP only so long as is necessary, and as they drop out, Section 162(m)(5) would likewise no longer apply. By contrast, PPACA and the mandate to purchase minimum essential coverage were intended to effect a permanent restructuring of the health insurance market, and Section 162(m)(6) was intended as a permanent cost-containment measure. Thus, while the EESA contemplated that, at some point in the future, there would be no more TARP participants, PPACA contemplates that there always will be health insurance companies providing minimum essential coverage, and thus Section 162(m)(6) will continue to apply indefinitely, even (or perhaps especially) if PPACA is implemented successfully.

Section 162(m)(6) applies in stages, based on the taxable year of the services to which compensation is attributable. Passed in 2010, Section 162(m)(6) does not cap deductions attributable to any compensation earned in taxable years beginning on or before December 31, 2009—even if that compensation is payable and deductible after 2012. Thus, deferred compensation earned before 2010 is completely grandfathered. The cap applies completely to both AIR and DDR earned in taxable years beginning after December 31, 2012, regardless (in the case of DDR) of the year paid or deductible. For taxable years 2010–2012, however, the rule is more complicated: the $500,000 cap will be applied to AIR and DDR earned in 2010–2012, but only to the extent it will limit the deduction for DDR paid (and otherwise deductible) in 2013 or later.

C. Post-Enactment Guidance: Notice 2011-2 and Proposed Regulations

Shortly after the enactment of the PPACA, the IRS issued Notice 2011-2, providing interim guidance on the application of Section 162(m)(6). Much of this guidance was repeated in the Proposed Regulations. To address concerns regarding the "tainting" aspect of the CHIP Aggregation Rule, both Notice 2011-2 and the Proposed Regulations contain a de minimis rule under which an Aggregated Group will not be treated as a CHIP if less than 2% of its gross revenues for the year are from premiums for providing minimum essential coverage (the "De Minimis Rule"). The Proposed Regulations add a new one-year grace period rule for Aggregated Groups that fall out of the De Minimis Rule for only a single year.[21] The Notice and the Proposed Regulations also clarify that reinsurance premiums are not treated as "premiums from providing health insurance coverage", and provide that compensation to independent contractors that is exempt from Section 409A will also be exempt from the deduction cap.[22] These rules were also incorporated into the Proposed Regulations.[23]

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[21] Notice 2011-2, section III.B; Prop Treas. Reg. § 1.162-31(b)(4)(iii). For further discussion of the De Minimis Rule, see Part **Error! Reference source not found.**.

[22] Notice 2011-2, section III.C, III.D. Under Treas. Reg. § 1.409A-1(f)(2), an independent contractor is not subject to Section 162(m)(6) if the independent contractor (1) is actively engage in the trade or business of providing services to recipients, other than as an employee or board member, (2) provides "significant services" to two or more "unrelated" persons, and (3) is not "related" to the CHIP or members

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The Proposed Regulations also contain a number of other clarified and elaborated definitions. In particular, the Proposed Regulations provide that an employer that self-insures is not a CHIP, although the Preamble to the Proposed Regulation (the "Preamble") states that a captive health insurance subsidiary will not be exempt if it otherwise meets the definition of a CHIP. The Preamble also indicates that only natural persons, and not legal entities, will be treated as Applicable Individuals.[24] The definition of "premiums" is further clarified to exclude "direct service payments"—i.e., payments made by health insurance issuers to healthcare providers on a capitated, prepaid, periodic or other basis, regardless of whether those providers bear some element of risk that the compensation is insufficient to pay the full cost of the healthcare services, or whether they are subject to local regulations applicable to insurers.[25]

The Proposed Regulations also provide a detailed set of rules setting out how DDR is to be attributed to particular services and service periods. Going well beyond the (relatively) simpler rules previously provided for attributing deferred deduction executive remuneration under Section 162(m)(5),[26] the Proposed Regulations first divide DDR into seven categories derived from the Section 409A regulations: account balance plans (account-like defined contribution plans tracking notional investments, functioning similarly to 401(k) plans),[27] nonaccount balance plans (generally functioning similarly to

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of its Aggregated Group. Prop. Treas. Reg. § 1.162-31(b)(7)(ii) (following the exception from Section 409A for certain independent contractors found in Treas. Reg. § 1.409A-1(f)(2)).

[23] Prop. Treas. Reg. § 1.162-31(b)(5) (defining and excluding "indemnity reinsurance contracts"), (b)(7)(ii) (excluding 409A-exempt independent contractors). An indemnity reinsurance contract is described as an agreement between a health insurance issuer and a reinsuring company under which the reinsuring company agrees to indemnify the health insurance issuer for all or part of the risk of loss under a specific policy or policies, and the health insurance issuer retains its liability to provide health insurance coverage to, and its contractual relationship with, the insured. Prop. Treas. Reg. § 1.162-31(b)(5)(ii). For example, premiums that a captive insurance company receives for reinsurance in connection with a fronting arrangement (which is a method typically employed in the life insurance and long-term disability benefits context where the fronting carrier functions as the primary carrier that issues the policy to the plan) would not be included in the 25% gross-premiums test.

[24] Preamble at 19,954; see Part IV.C.

[25] Prop. Treas. Reg. § 1.162-31(b)(5)(iii).

[26] See Notice 2008-94, Sec. III.B, Q&A 9.

[27] Under the Section 409A regulations, an account balance plan is "plan under the terms of which a principal amount (or amounts) is credited to an individual account for [a service provider], the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the [service provider] are based solely on the balance credited to the individual account." Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(A); see Treas. Reg. § 1.409A-1(c)(2)(i)(A) (defining "account balance plan" under the Section 409A regulations by reference to Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(A)).

a traditional defined benefit pension plan),[28] equity-based remuneration (such as stock options or restricted stock), involuntary separation pay, reimbursements, split-dollar life insurance and a residual category for DDR that does not fall into one of the other six. The Proposed Regulations then propose a different rule (or in the case of account balance plans, two alternative rules) governing how DDR in each category is attributed to taxable years of CHIPs and services of Applicable Individuals.[29]

The Proposed Regulations conclude with a number of transitional rules that apply when an entity becomes a CHIP as a result of an acquisition or similar corporate transaction. If an employer becomes a CHIP solely as a result of such a transaction, it is generally not treated as a CHIP for the year in which the transaction occurs. This exception is not available, however, with respect to remuneration paid to Applicable Individuals of health insurance issuers that would otherwise be CHIPs during the year in which the transaction occurs.[30]

IV. Comments

A. Transactional issues

Under the Proposed Regulations, the members of a non-CHIP Aggregated Group could become CHIPs as a result of a merger, acquisition of assets or stock, disposition, reorganization, consolidation, or separation, or any other transaction (including a purchase or sale of stock or other equity interest) resulting in a change in the composition of the Aggregated Group (a "Corporate Transaction"). It is our understanding that there is a concern developing in the market that there could be a chilling effect on Corporate Transactions where one of the parties holds an ancillary health insurance business, due to the possibility that those transactions could inadvertently result in the application of Section 162(m)(6) to the entire resulting Aggregated Group. The Proposed Regulations contain a number of provisions involving Corporate Transactions governing when and under what circumstances the CHIP Aggregation Rule will cause the members of an Aggregated Group acquiring or disposing of a CHIP to themselves start or cease being CHIPs.

CHIP Entering an Aggregated Group. Under the Proposed Regulations, if an entity that was not previously a CHIP would become a CHIP solely as a result of a Corporate Transaction (e.g., because another entity that is already a CHIP becomes a member of that entity's Aggregated Group), that entity will not be treated as a CHIP until the subsequent taxable year for which it qualifies as a CHIP under the general rules for

[28] The Treasury Regulations define "nonaccount balance plan" negatively as "a plan that is not an account balance plan", Treas. Reg. § 31.3121(v)(2)-1(c)(2)(i), to the extent it is not also another type of deferred compensation plan. See Treas. Reg. § 1.409A-1(c)(2)(i)(C).

[29] Prop. Treas. Reg. § 1.162-31(d). See Part IV.D.

[30] Prop. Treas. Reg. § 1.162-31(f).

determining status as a CHIP.[31] The Preamble explains that the intent of the delay before an entity will become a CHIP as a result of a Corporate Transaction is to provide transitional relief to ease the administrative burdens of applying the deduction limit.[32] This rule does not apply to any entity that was otherwise a CHIP before the Corporate Transaction.[33] Thus, an acquired CHIP remains subject to Section 162(m)(6) even during the transition period during which the remainder of its new Aggregate Group is given a reprieve.

CHIP Leaving an Aggregated Group. When an entity that was previously a CHIP (including as a result of the CHIP Aggregation Rule) leaves an Aggregated Group, the Proposed Regulations address what happens to that entity if its taxable year closes (e.g., because the entity is leaving, or entering, a Section 1502 consolidated group). First, the entity will be tested for CHIP status based on that short taxable year.[34] Second, if that entity is determined to be a CHIP in that short taxable year, the Proposed Regulations also contain a generous rule providing that the Section 162(m)(6) cap for that short taxable year will be a full $500,000 (i.e., it will not be pro-rated).[35]

1. CHIP Entering an Aggregated Group

Proposal

We recommend that the rule for an Aggregated Group acquiring a CHIP be modified so that an entity that becomes a CHIP solely as a result of a Corporate Transaction in which a CHIP becomes a member of that entity's Aggregated Group not become a CHIP until the first taxable year beginning at least six months after the closing date of the Corporate Transaction (rather than simply at the beginning of the next taxable year). This modification would ensure a meaningful transition period following all Corporate Transactions, regardless of when in the taxable year the transaction closes.

Discussion

The acquisition of a CHIP by an Aggregated Group has the potential to dramatically affect the compliance burden on other members of the Aggregated Group. As a result of the CHIP Aggregation Rule,[36] unless the De Minimis Rule applies, every other member of the Aggregated Group will become subject to a set of technical rules

[31] Prop. Treas. Reg. § 1.162-31(f)(1)(ii)(A).

[32] See Preamble at 19,958.

[33] Prop. Treas. Reg. § 1.162-31(f)(1)(ii)(B) and (iii)(B).

[34] Prop. Treas. Reg. § 1.162-31(f)(1)(iii)(A).

[35] Prop. Treas. Reg. § 1.162-31(f)(1)(iii)(C). If the entity is a CHIP for the immediately succeeding short taxable year, its Section 162(m)(6) cap for that short taxable year will also be a full $500,000.

[36] See note 20, *supra*, and accompanying text.

under Section 162(m)(6), including a complex attribution regime for DDR, which may be completely new to the individuals operating its benefit plans and tax compliance processes. Those individuals will now be required to track AIR and DDR payments or accruals as they are earned and calculate resulting deduction limitations under the allocation rules. Employers wishing to "comply" with Section 162(m)(6) by reducing compensation may find it necessary to renegotiate existing employment relationships, or, if that fails, find new service providers who will work for less compensation. In short, while entities that were CHIPs prior to the Corporate Transaction may not face any additional burden because of the transaction, entities previously unaffected by Section 162(m)(6) may need time to be ready for the obligations associated with CHIP status.

The transition period relief included in the Proposed Regulations is therefore welcome. Our concern, however, is that simply deferring CHIP status until the next taxable year may not always give acquirors sufficient lead time before beginning CHIP status, as Corporate Transactions may occur at any time during a taxable year. Agreements governing Corporate Transactions generally provide for the closing to occur during a limited window of several business days following the satisfaction of all relevant closing conditions, the timing of which is often largely outside the control of both parties. As a result, while the proposed transition period relief rules may provide more than enough preparation time to entities that close a Corporate Transaction early in a taxable year, it may not provide much time at all to an Aggregated Group that acquires a CHIP in a transaction that closes near the end of a taxable year. For example, under the Proposed Regulations, a calendar year taxpayer that acquires a CHIP in a Corporate Transaction that closed on December 31, 2013, would be treated as a CHIP effective January 1, 2014, the very next day. But if the closing were delayed until the next business day, January 2, 2014, the acquiror would not become a CHIP until January 1, 2015. Parties frequently work together to try to schedule closings on the last day of a month or, if possible, the last day of a year, because it simplifies financial reporting, tax reporting and regulatory compliance. The rule in the Proposed Regulations would at best be a trap for unwary acquirors, and at worst could interfere with the timing of the closing of Corporate Transactions by providing an acquiror with an incentive to delay the satisfaction of the conditions to closing.

Accordingly, we believe the transition rule should be modified to provide that an entity not become a CHIP as a result of a Corporate Transaction until the first taxable year commencing at least six months after the closing date of the Corporate Transaction. This would guarantee all entities, regardless of the timing of a Corporate Transaction, a "grace period" of no less than six months following the closing date of the Corporate Transaction to prepare to comply with Section 162(m)(6) or to dispose of unwanted health insurer subsidiaries before those entities subject the entire Aggregated Group to Section 162(m)(6). Under the example above, therefore, the acquiror would not become a CHIP until January 1, 2015, whether the Corporate Transaction closed on December 31, 2013 or January 2, 2014. Any entity that was already a CHIP before the Corporate Transaction would remain a CHIP (and thus subject to Section 162(m)(6)) during this transition period; only those entities that were non-CHIPs before the transaction would be given the additional time to prepare for compliance with Section 162(m)(6).

Of course, even under our proposed rule, there would still be a "cliff" at mid-year—an acquiror that closes a Corporate Transaction on June 30, 2014 would become a CHIP on January 1, 2015; closing a day later on July 1 would entail becoming a CHIP a year later on January 1, 2016. Such cliff effects are the inevitable consequence of any annual testing period, and of the annual accounting requirement generally. But the impact of being on the wrong side of the cliff would be much lower for the taxpayer. Under our "cliff," the taxpayer would have either six months or 18 months to come into compliance; under that of the Proposed Regulations, it would have either one day or one year. As noted above, the fisc would still be protected, as Section 162(m)(6) would continue to apply to any entity that was a CHIP before the transaction (which would include the actual health insurance provider CHIP as well as any other members of that CHIP's prior Aggregated Group that were also acquired in the same transaction).

We note that even longer relief is provided under other Sections of the Code. For example, the plan non-discrimination requirements under Sections 401(a)(4), 401(a)(26) and 410(b), which (like the CHIP Aggregation Rule) also turn on membership in a Section 414 controlled group, each provide transition periods that extend to the end of the year following the year in which a transaction occurs.[37]

2. CHIP Leaving an Aggregated Group: What Happens to the Remaining Group?

Section 1.162-31(f) of the Proposed Regulations provides that when an Aggregated Group completes a Corporate Transaction in which it disposes of a health insurance issuer that had caused the group to be subject to the deduction limitations under Section 162(m)(6) (the "Transferred CHIP"), not only will the Transferred CHIP itself continue to be subject to the deduction limitations under Section 162(m)(6) for the remainder of its taxable year or new short taxable year following the completion of the transaction, but the other entities of the Aggregated Group (i.e., the seller group) will also continue to be subject to the deduction limitations under Section 162(m)(6) for the taxable year of the seller group in which the transaction is completed. Example 2 in Proposed Regulations Section 1.162-31(f)(3) illustrates this with an Aggregated Group all of the members of which are treated as CHIPs because of a single member (F) that is a health insurer. When F leaves on May 1, 2016, the other members of its former Aggregated Group remain CHIPs for their entire year ending December 31, 2016, "because they were in an aggregated group with F for a portion of their taxable year." The example does not indicate the amount of revenue F generated in the portion of the year in which it was a member of the Aggregated Group, nor does it address whether or to what extent the remaining members might be eligible for the De Minimis Rule for 2016.

[37] See Section 410(b)(6)(C)(ii) (defining the relevant "transition period" as "ending on the last day of the 1st plan year beginning after the date of such change").

Proposal

The Proposed Regulations should provide that, if during an Aggregate Group's taxable year, the group disposes of a Transferred CHIP (such year, the "Transaction Year"), the De Minimis Rule test should be applied to the Aggregated Group in the Transaction Year by taking into account the revenues of the Transferred CHIP only for the portion of the Transaction Year in which it was a member of that Aggregated Group.

Discussion

The provisions in the Proposed Regulations addressing what happens when a Transferred CHIP leaves an Aggregated Group should be clarified. Presently, they specifically address only the status of the Transferred CHIP itself, and even then only where that CHIP has a short taxable year because of the Corporate Transaction. In that case, the Proposed Regulations tell us, the De Minimis Rule will apply to the Transferred CHIP for that short year *only if* the De Minimis Rule applied to that CHIP in its prior taxable year. With the exception of Example 2 (summarized above), however, the Proposed Regulations are silent as to what happens to the remaining members of the Aggregated Group that is disposing of the CHIP. In particular, they do not specify how the De Minimis Rule should apply to the Aggregated Group the Transferred CHIP leaves behind.

The absence of any additional special rules should mean that the Aggregated Group that is left behind is eligible for the De Minimis Rule based on a simple calculation of the revenue earned by the members of that group during the portion of the group's taxable year during which they were members of that Aggregated Group, regardless of whether the De Minimis Exception was met by the Aggregated Group in the prior year and regardless of whether the departing members' taxable year closes on the departure date. It would be clearer if this were explicitly stated. This is illustrated by the following example.

> Example: Group A, all of the members of which are calendar year taxpayers, contains a single health insurer member, C. If C earns, on an annual basis, 10% of Group A's gross revenue, all of which is from the provision of minimum essential coverage, it would cause the other members of Group A to be considered CHIPs. Assuming that C earns the same amount of revenue in each month, if Group A were to dispose of C in a Corporate Transaction on December 1 of the Transaction Year, the other members of Group A would remain CHIPs through the end of their taxable year, since C's gross revenue from providing minimum essential coverage during the period in which it was a member of the Aggregated Group would still have made up approximately 9.2% of the gross revenue of the Aggregated Group as a whole (10% x 11/12). If, however, the Corporate Transaction closed on February 1 of the Transaction Year, then C's minimum essential coverage revenue during the year would only account for 0.8% of the gross revenue of the Aggregated Group, well below the threshold for the De

Minimis Exception. In the latter case, Group A should be permitted to take advantage of the De Minimis Exception for the Transaction Year.

We believe that, solely for purposes of testing the CHIP status of the members of the selling Aggregated Group, the De Minimis Rule should be applied as if the taxable year of the Transferred CHIP terminated on the date it left the group, regardless of whether the year actually ends for other tax purposes. In most cases, such as the sale of a subsidiary out of or into a Section 1502 consolidated group or the Section 708(b)(1)(B) technical termination of a partnership follow the sale of more than 50% of its capital and profits interests, the Transferred CHIP's taxable year will end for general income tax purposes as well, and so the CHIP and the selling Aggregated Group will already need to compute this partial-year information . In some cases, however, such as Aggregated Groups that are "affiliated service groups" under Section 414(m) and (o), the Transferred CHIP may not be consolidated with other members of the selling Aggregated Groups for either tax or financial accounting purposes. A selling Aggregated Group in that situation would therefore need to secure the partial-year information from the acquiror in order to make the De Minimis Rule calculations . We believe that in many cases the Aggregated Group is likely to prefer this additional administrative burden to being treated as a CHIP for the entire Transaction Year.

It is important to note that this proposal would only affect the Aggregated Group left behind. The Transferred CHIP would remain a CHIP, whether as a standalone entity or in the hands of a new Aggregated Group.

3. CHIP Leaving an Aggregated Group: What Happens if an Aggregated Group Sells Its Designated CHIP and One or More CHIPs Remain in the Group?

In determining whether each member of an Aggregated Group is treated as a CHIP in a particular taxable year, the "parent entity" of the Aggregated Group is deemed to be a CHIP for its taxable year with which, or in which, ends the taxable year of the health insurance issuer that is an active CHIP (the year of the parent entity, the "Testing Year"). Every other member of the Aggregated Group is a CHIP for its taxable year that ends with, or within, the Testing Year.

In the case of parent-subsidiary Aggregated Groups under Section 414(b) and (c), the Proposed Regulations treat the common parent of the Aggregated Group as the parent entity.[38] In the case of an Aggregated Group that is an "affiliated service group" under Section 414(m) or (o), however, the Proposed Regulations propose a more complicated rule. If only one member of such an Aggregated Group is a CHIP, then that CHIP will be treated as the parent entity.[39] Where there are multiple CHIPs within an Aggregated Group, however, the Proposed Regulations allow the Aggregated Group to designate

[38] Prop. Treas. Reg. § 1.162-31(b)(3)(i)(A)

[39] Prop. Treas. Reg. § 1.162-31(b)(3)(i)(B).

which CHIP will be the parent entity (the "Designated CHIP"), so long as the Aggregate Group does so on a consistent basis in that and all future taxable years.[40] The Proposed Regulations do not indicate what would happen if the Designated CHIP were to leave the Aggregated Group, whether as a result of a Corporate Transaction or otherwise, and the Preamble requested comments on the circumstances in which a new parent ought to be designated.

Proposal

We recommend that where a Designated CHIP leaves an Aggregated Group, then the members of the Aggregated Group must designate a successor CHIP with the same taxable year as the predecessor Designated CHIP. If there is no successor CHIP with the same taxable year, then the Aggregated Group should be free to select any other member CHIP as the Designated CHIP, the existing Testing Year would end on the date the Designated CHIP leaves the Aggregated Group and there will be a Testing Year that runs from the date after the predecessor Designated CHIP leaves the taxable group and ending on the last day of the new Designated CHIP's taxable year (a new short Testing Year).

Discussion

Ideally, the departure of the predecessor Designated CHIP should not affect the Testing Year of the other entities. A rule that requires members of the Aggregated Group to maintain the same taxable year for testing purposes that they had before the Corporate Transaction would reduce the potential for abuse, and would not entail any additional administrative burden. Requiring that members designate a new Designated CHIP with the same taxable year as the predecessor Designated CHIP achieves just this result.

Where no such entity has the same taxable year, however, then some transition will be necessary. In that case, the simplest solution is to allow members of an Aggregated Group to select a new member CHIP as the designated CHIP, and allow a transition to its taxable year as the applicable Testing Year as soon as possible. This would result in the end of the current Testing Year on the date of the Corporate Transaction and the beginning of a new Testing Year beginning on the date after the Corporate Transaction and ending on the last day of the new Designated CHIP's taxable year. The creation of short Testing Years is consistent with the approach to short years in the Proposed Regulations, which respects short taxable years when CHIPs enter and leave consolidated groups as a part of Corporate Transactions, and even expressly provides that the $500,000 cap for such short taxable years is not subject to pro-ration.[41]

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[40] Prop. Treas. Reg. § 1.162-31(b)(3)(ii).

[41] Prop. Treas. Reg. § 1.162-31(f)(1)(iii). Alternatively, the predecessor Designated CHIP's taxable year could continue as the relevant Testing Year until it would otherwise end. At that point, the new Designated CHIP's short Testing Year would begin, with the Testing Year beginning on the day after the last day of the predecessor Designated CHIP's taxable year and ending on the last day of the new Designated CHIP's taxable year). The drawback to such a rule, however, would be that, between the date

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> Example: Group Q is an Aggregated Group that is an affiliated service group. Its members, all of which are CHIPs, are A, B, C, D and E. A, B and C are calendar year taxpayers, D's taxable year ends each November 31, and E's taxable year ends June 30. Because there is no common parent, Group Q elects A as the Designated CHIP, and hence Group Q's Testing Year is the calendar year.

As a result of a Corporate Transaction, A leaves Group Q. Under our proposed rule, Group Q would be required to designate either B or C as a successor Designated CHIP, as they are also calendar year taxpayers. If, however, B and C also both left Group Q, then Group Q would be permitted to name either D or E as the successor. Assuming that B and C leave on February 1, and E is the new Designated CHIP, then the existing Testing Year is cut short and ends on February 1, there would be a short Testing Year from February 2 (the day after the Corporate Transaction) until June 30 (the end of E's taxable year), and a new full Testing Year would begin on July 1.

B. Captive Insurance Companies

The Proposed Regulations provide that an employer is not a CHIP solely because it maintains a "self-insured medical reimbursement plan."[42] Notice 2011-2 had requested comments with respect to the treatment of employers which self-insure and employers which are captive insurance companies.[43] The Proposed Regulations are silent as to captives, but the Preamble explains as follows:

> In response to a request for comments in Notice 2011-2, commenters suggested that an employer that sponsors a self-insured medical reimbursement plan should not be treated as a covered health insurance provider because benefits under this type of plan should not be treated as health insurance coverage for purposes of section 162(m)(6) if the employer assumes the financial risk of providing health benefits to its employees and limits the availability of benefits only to employees (which may include former employees). The Treasury Department and the IRS

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the predecessor Designated CHIP leaves the Aggregated Group and the end of its taxable year, the entire Aggregated Group would be tested based on the taxable year of an entity that is no longer in the group.

[42] Prop. Treas. Reg. § 1.162-31(b)(4)(ii). For this purposes, a "self-insured medical reimbursement plan" means a separate written plan maintained for the benefit of employees (including former employees) that provides for reimbursement of employee medical expenses referred to in Section 105(b) and that does not provide for reimbursement under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies. *Id.*

[43] The Notice stated: "Specifically, comments are requested on the application of the deduction limitation to remuneration for services performed for insurers who are captive or who provide reinsurance or stop loss insurance, and specifically with respect to stop loss insurance arrangements that effectively constitute a direct health insurance arrangement because the attachment point is so low."

> agree that an employer should not be treated as a covered health insurance provider under these circumstances. Accordingly, these proposed regulations provide that an employer is not a covered health insurance provider solely because it maintains a self-insured medical reimbursement plan. . . . A captive insurance company, however, is treated as a covered health insurance provider under these proposed regulations if it is a health insurance issuer that is otherwise described in section 162(m)(6)(C).

While the Preamble does not elaborate on the rationale for this treatment of captives, this may be because Treasury and the IRS did not receive sufficient comments on captives to determine that captives should be subject to any special rules.[44] We note that an employer that uses a captive insurance company to provide health insurance to its employees will itself be subject to Section 162(m)(6) so long as it is in the same Aggregated Group as the captive (which it is likely to be), whereas an employer that uses self-insurance to provide health insurance to its employees will not be. We understand, however, that, apart from Section 162(m)(6), much attention has been paid to the U.S. federal tax treatment of captive insurance companies and their affiliates by the IRS and the tax community, and, as non-experts, we are not qualified to comment on how captives (and their affiliates) should be treated for purposes of Section 162(m)(6).[45]

C. Applicable Individuals and Entities That Provide Services to a CHIP

Section 162(m)(6) applies only to compensation paid for services provided by "an individual", whether an officer, director, employer or other service provider.[46] The Proposed Regulations follow this, but also provide an exception for certain independent contractors. Under this exception, an independent contractor is not subject to Section 162(m)(6) if the independent contractor (1) is actively engaged in the trade or business of providing services to recipients, other than as an employee or board member, (2) provides "significant services" to two or more "unrelated" persons, and (3) is not "related" to the CHIP or members of its Aggregated Group.[47] Independent contractors meeting these conditions have historically been excluded from being subject to Section 409A, and were excluded from Section 162(m)(6) by Notice 2011-2.

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[44] We were not able to find any comments letters discussing captives and two years after Notice 2011-2 was issued, a Treasury official publicly stated that Treasury was still looking for comments on captives. *See* Shamik Trivedi, Guidance on Compensation Deduction Limits for Healthcare Providers Next on Treasury's List, Tax Notes Today (Nov. 13, 2012). *Compare* 2011 TNT 61-26 (Mar. 23, 2011)(comment letter from Vermont Captive Association addressing other issues under Section 162(m)(6)).

[45] For the same reason, we do not respond in this report to the Preamble's request for comments on the extent to which it would be inappropriate to treat "direct service payments" made by government entities to health care providers as "premiums" for purposes of Section 162(m)(6).. Preamble at 19,953.

[46] See Section 162(m)(6)(F)(defining "Applicable Individual" as "any individual (i) who is an officer, director, or employee . . . , or (ii) who provides services for or on behalf of such [CHIP]").

[47] Prop. Treas. Reg. § 1.162-31(b)(7)(ii).

The Preamble confirms that Section 162(m)(6) does not apply to compensation paid to legal entities for services.[48] The Preamble, however, also expresses concern that CHIPs might attempt to avoid the application of Section 162(m)(6) by encouraging service providers who would otherwise be Applicable Individuals to provide services through entities (including entities owned or controlled by the service providers themselves). The Preamble seeks comments regarding how final regulations might address this potential abuse.

Proposal

To that end, we propose that, when a CHIP reports remuneration payments on a Form 1099 or W-2 issued directly to a natural person, that natural person should be considered the service provider for purposes of Section 162(m)(6); and when a CHIP reports remuneration as being paid to a service provider entity, and that reporting is not found to be incorrect (under Section 6041), the entity should be respected as the service provider for Section 162(m)(6) purposes.

Discussion

We recognize the possibility of service provider entities being used to avoid the Section 162(m)(6) limitation. Indeed, in many cases it would not be procedurally or administratively difficult for an individual to form an S corporation or a partnership and provide services to the CHIP through the entity. After considering many ways to approach this issue (as discussed below), we settled on our proposal above primarily because (i) we believe, for the reasons discussed below, that this proposal, in combination with existing doctrine governing the distinction between employees and independent contractors, will eliminate most of the potential abuses and thus leave open only limited avenues for abuse, (ii) all the broader potential alternatives we considered essentially amount to applying Section 162(m)(6) to services provided by entities, and the statute simply does not provide for that, and (iii) any rule that looks through an entity and treats the entity as an individual for this purpose would need to be straightforward, clear and administrable (and none of the other alternatives we considered fit these requirements).

We think the potential for abuse that would remain after adoption of our proposal is likely to be limited for several reasons. First, in order for an entity to be respected as such under the rule we are proposing, the individual providing services through the entity must not have the status of "employee" to the CHIP—that is, the individual, even if considered to be providing services in his or her individual capacity, would nonetheless be considered an independent contractor for other federal tax purposes, such as income tax, FICA and FUTA. There already exists a developed body of law distinguishing employees from independent contractors for tax purposes and providing serious consequences for mischaracterizing employees as independent contractors.[49] If the

[48] Preamble at 19,954.

[49] For mischaracterizing compensation payments to a service provider properly characterized as an employee, an employer would be liable for FICA withholding under Section 3102(a), FUTA withholding

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individual is an "employee" for purposes of these rules, then the individual would be treated as an individual for Section 162(m)(6) purposes under our proposal.

Second, we think the scope of potential abuse is limited because, for a variety of non-tax reasons, it is arguably unlikely that CHIPs will attempt to convert their most senior executive officers (or permit those executives to convert) into independent contractor entities in order to avoid Section 162(m)(6). Given corporate governance requirements, it would likely be untenable for a board of directors to have the responsibilities and authority of a senior executive given to an entity (and then, through the entity, to an individual) that has the status of independent contractor and whose work the board does not have the legal authority to direct. In the case of publicly listed companies, we understand there to be additional complications, including under federal securities laws, to implementing such an arrangement. It would be our recommendation that this issue be revisited if CHIPs do in fact start appointing entities to fill senior executive roles. We acknowledge, however, that Section 162(m)(6) is not limited to senior executives, and that the constraint we raise here may not apply to a broad range of executives within a business.

This leaves the case where the services in question are provided under circumstances where the service provider is properly classified as an independent contractor, and the independent contractor exception described above does not apply. As noted above, that exception will apply, generally, if the entity provides services to at least two recipients and is not related to the other service recipients or the CHIP.

Individual service providers already occasionally provide services through legal entities, rather than directly, for various reasons, such as liability management. Service recipients will frequently enter into relationships with these entities on the assumption that particular individuals will provide services. Information reporting rules require service recipients to report the correct recipient of the payments or incur penalties under Section 6722 for failure to furnish correct payee statements.[50] A service recipient may insist that, regardless of the legal form of the service provider, the service recipient will report the relevant individual as the recipient of the income on Form 1099 for purposes of reporting under Section 6041. But the penalties under Section 6722 are very small, especially compared to the value of the tax benefits a service recipient is likely to obtain

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under Section 3301 and income tax withholding under Section 3401, along with corresponding interest and penalties in the event of a misclassification. Additional legal penalties may apply under federal, state and local employment and similar laws, including ERISA, state wage protection laws, overtime and disability laws, and many others.

[50] Section 6721 imposes a penalty of $100 for each information return that includes incorrect information. Such a penalty would apply to incorrect information on a Form 1099-MISC issued to an independent contractor. See Section 6724(d)(1) (defining "information return"). In light of the emphasis our proposal places on accurate reporting, we would encourage the IRS to pursue the enforcement of the applicable reporting requirements in the appropriate cases.

from being able to claim deductions without application of the Section 162(m)(6) limitation.

One simple way of approaching the potential for abuse of the service entity form would be to say that any entity that provides services only to the CHIP, and no other recipients, is treated as an Applicable Individual. That approach would be overbroad though because Section 162(m)(6) does not provide that it applies to entities that provide services, even if the entity provides services only to the CHIP. This rule could be further limited to entities that have a single employee, who provides services on behalf of the entity, and only to the CHIP. A variant of this approach would be to look at the percentage of the entity's revenue or gross income that was derived from the CHIP.

Such a rule could be so easily circumvented by having two individuals in the entity instead of one. Any rule focused on entities employing or owned by a single service provider, or providing services to a single CHIP, would simply encourage otherwise independent service providers to join together to form entities providing services from multiple providers to multiple CHIPs, under internal compensation arrangements (such as bonuses, commissions or partnership allocations) that could be expected to replicate those that each service provider could expect were it to contract directly with the CHIP on an exclusive basis. Distinguishing such an entity of convenience from a genuine partnership would be almost impossible, even in principle. For example, an independent CPA, whose remuneration would otherwise be subject to Section 162(m)(6) to a CHIP, could go to work for a Big Four accounting firm on the understanding that the CHIP would engage that firm solely for his services and that he would receive from the firm what the CHIP would otherwise have paid him.

Another approach would be an intent-based test, asking whether an entity was utilized for the primary or principal purpose of avoiding the application of Section 162(m)(6). We believe that such a test would likely be unworkable because it may well be the case that entity-service providers will frequently be chosen over individual-service providers in part on account of Section 162(m)(6). For example, in evaluating bids in response to a request for proposal ("RFP"), CHIPs are likely to prefer bids submitted by entities over otherwise identical ones submitted by individuals on the grounds that payments to the former would be entirely deductible. Many such service providers may already operate through entities for non-tax-reasons;[51] nevertheless, their entity status would give them an advantage in bidding for business from CHIPs. Knowing this, potential service providers are more likely to incorporate or otherwise act through entities in order to ensure their bids remain competitive. It is not unreasonable to expect that over time bids for CHIP RFPs will come only from entities, without any intervention or direct encouragement by any particular CHIP. This state of affairs does not strike us as "abusive," but rather as merely the sort of common market distortion that inevitably

[51] As noted above, individuals may act through entities for all many non-tax reasons, such as limiting liability. It may be that changes in legal rules may cause service providers who once provided services directly as individuals to incorporate for regulatory or liability-limiting reasons. Thus, a rule that relies on historical practice may also be overinclusive for other reasons as well.

results when a tax provision systematically favors one transaction structure over otherwise economically identical alternatives (in this case, the provision of services through entities rather than through individuals). Thus, we believe that an anti-abuse rule that asks whether entities were used for the purpose, or with the intent, of avoidance of Section 162(m)(6), or whether entities were used for services that were historically provided by natural persons, would sweep too broadly.

Lastly, one could also imagine an anti-abuse rule turning on whether, regardless of the form of the transaction, particular individuals were providing services. The Preamble, for example, implies that it would be abusive for CHIPs to encourage *current* employees or contractors to form entities and provide services through them. This hypothetical rule could ask whether individuals were recently employed or contracted with a CHIP in their individual capacity. We believe such a rule would also prove problematic, however. All entities must act through natural persons, and it is common for independent contractors to provide services to a particular service recipient through one or more identifiable (or even contracted) individuals. It would seem perverse, however, if the presence of a former employee could "taint" an entity with respect to a service recipient precisely because of that service provider's experience with that service recipient. Such a rule would also seem to be ultimately ineffective, as it would do nothing to prevent an otherwise identical entity service provider (but without former CHIP employee involvement) from providing the same services on a fully deductible basis. Likewise, a rule that turned on the proportion of time that particular individuals at an entity spent providing services to a single CHIP could be overinclusive—while a given consulting firm may provide services to many customers at once, its employee consultants might work exclusively for only one client at a time.

Rather than adopting any of these alternatives, we believe the best approach is to require a consistency rule: if a CHIP is required to look through the entity to the underlying natural person for purposes of Section 6041 information reporting, then it must also treat that natural person as an individual recipient for purposes of Section 162(m)(6), and thus as an Applicable Individual. Such a rule would be easily administrable, as it would build on a determination service recipients already make in paying service providers and on the existing enforcement mechanisms and penalties for reporting payments to service providers provided by the information reporting rules, and would not otherwise distort the market for service providers. In particular, it would seem more than capable of handling the most obvious abuse case that appears to be driving the concern expressed in the Preamble, namely, the highly paid CHIP executive who resigns only to establish an entity-based consultancy to provide identical services the next day.

D. DDR Attribution Rules

As noted above,[52] under Section 162(m)(6), the $500,000 cap applies, with respect to each taxable year in which a taxpayer is a CHIP, to the sum of both AIR

[52] See note 19, *supra*, and accompanying text.

currently deductible in that year and DDR attributable to that year. The Proposed Regulations contain a number of rules for attributing DDR back to earlier taxable years.[53] Below, we detail some of the administrative burdens associated with the proposed attribution rules and recommend changes that would greatly alleviate those burdens and improve the rules.

1. Grandfathered Benefits and the Consistency Rule Under Account Balance Plans

The Proposed Regulations allow CHIPs to choose between two attribution methods for account balance plans, the "standard method" and the "alternative method." CHIPs must use the same method for all account balance plans and all taxable years (the "Account Balance Consistency Rule").[54]

Under the standard method, DDR attributed to a taxable year equals the account balance at the end of the year, increased by any payments during the year that reduced the account balance and decreased by the account balance at the end of the prior year. While the standard method is relatively easy to administer on an ongoing basis, it significantly limits the intended benefit of the grandfather rule of the statute.[55]

Under the alternative method, contributions of principal are attributed to the year in which they are added to the account balance, and subsequent earnings or losses on a contribution that occur in later years are attributed to the same taxable year as the related contribution.[56] While the alternative method preserves the benefit of the statute's grandfather rule, it is general expected to be administratively complex on an ongoing basis.

Proposal

We recommend that the final rules allow CHIPs to use the alternative method to determine grandfathered amounts in account balance plans, even if they use the standard method regarding the attribution of nongrandfathered amounts. Under this proposal, the total DDR attributed to taxable years 2010 and later (i.e., non-grandfathered amounts) is the same as under the alternative method, but the attribution to specific years is different and administratively easier.

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[53] See notes 26–30, *supra*, and accompanying text.

[54] Prop. Treas. Reg. § 1.162-31(d)(3)(ii)(D).

[55] Prop. Treas. Reg. § 1.162-31(d)(3)(i)(A).

[56] Prop. Treas. Reg. § 1.162-31(d)(3)(ii).

Discussion

Section 162(m)(6) grandfathers compensation attributable to services performed in taxable years beginning before 2010, regardless of when the compensation becomes deductible.[57] The Proposed Regulations require CHIPs to use the same attribution rule selected for account balance plans to attribute amounts to taxable years beginning before 2010, ignoring any substantial risks of forfeiture. Here, the alternative method has a clear advantage because earnings credited on principal additions made before 2010 will be fully deductible when paid. Under the standard method, such earnings are attributed to the year credited, subjecting them to the deduction cap. Therefore, if these rules are retained without modification, many CHIPs that sponsor account balance plans with pre-2010 deferrals will be pushed into choosing the alternative method to preserve the full benefit of grandfathering for already credited compensation. Combined with the Account Balance Consistency Rule, this would have the effect of locking employers into the alternative method from 2010 on, potentially entailing enormous ongoing administrative burdens as the plan continues to separately track earnings (losses) on each year's principal additions from and after 2010.

Relaxation of the Account Balance Consistency Rule could greatly simplify administration without creating opportunities for abuse. If CHIPs could use the alternative method to determine grandfathered amounts and the standard method to attribute nongrandfathered amounts to taxable years, they could take full advantage of the grandfather rule without taking on the burden of separately tracking earnings (losses) on each year's principal additions. Recordkeepers should generally be able separately to track two subaccounts — one for pre-2010 principal additions and the other for 2010 and later additions—without the extensive system modifications that might be required to track each year from and after 2010 separately.

As illustrated in the example below, under this proposal, the total amount of DDR attributed to 2010 and later tax years is the same as under the alternative method, but the attribution to specific years is different. Also, the attribution under our proposal would be consistent with that which is proposed for nonaccount balance plans where the grandfathered amount may increase in subsequent taxable years to equal the present value of the benefit the Applicable Individual actually becomes entitled to receive (in the form and at the time actually paid), determined under the terms of the plan in effect on the last day of the last taxable year beginning before 2010, without regard to any further services rendered after that date.

Example – Attribution of grandfathered amount

CHIP B, a calendar-year taxpayer, provides a nonqualified account balance benefit to certain executives. Each year, a principal amount is credited to the account and

[57] Grandfathering under Section 162(m)(6) is discussed generally in Part III.B. Other issues relating to grandfathering of DDR are discussed in Parts IV.D.5 and IV.D.9.

interest is credited on the prior year-end account balance at the prior December 31 Moody's average corporate bond rate. The account balance is paid December 31 following separation from service. Gerry, a long-service participant, had an account balance of $600,000 on Dec. 31, 2009. The table below shows how Gerry's account balance evolves over the period from December 31, 2009, to the payout of the account on December 31, 2017, including the amount attributed to each tax year from 2010-2017 under the standard and alternative rules in the proposed regulations.

							Attribution	
Year	**Rate of return**	**Account balance prior 12/31**	**Principal Addition**	**Earnings**	**Benefit payments**	**Account balance at 12/31**	**Standard Method: F+G-C**	**Alternative Method: D with earnings to 12/31/17**
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**
2010	5.84%	$600,000	$50,000	$35,040	0	685,040	85,040	69,933
2011	5.44%	685,040	52,500	37,266	0	774,806	89,766	69,642
2012	4.36%	774,806	55,100	33,782	0	863,688	88,882	70,037
2013	4.08%	863,688	57,900	35,238	0	956,826	93,138	70,711
2014	4.50%	956,826	60,800	43,057	0	1,060,683	103,857	71,055
2015	5.00%	1,060,683	63,800	53,034	0	1,177,517	116,834	71,011
2016	5.25%	1,177,517	67,000	61,820	0	1,306,337	128,820	70,853
2017	5.75%	1,306,337	70,400	75,114	1,451,851	0	145,514	70,400
Total amount attributed to 2010-2017 tax years							$851,851	$563,641

The standard method attributes $288,210 more to Gerry's 2010–2017 service than the alternative method. This difference equals the total investment earnings from January 1, 2010 through December 31, 2017, on Gerry's $600,000 account balance at December 31, 2009, determined as $600,000 × [(1.0584 × 1.0544 × 1.0436 × 1.0408 × 1.0450 × 1.0500 × 1.0525 × 1.0575) – 1].

Under our proposed method, the amount attributed to Gerry's 2010–2017 service would total the same $563,641 as under the alternative method, but the attribution to each of those years would be determined under the administratively simpler standard method, as illustrated in the table below:

Year	Rate of return	Grandfathered balance at 12/31: C at prior year-end × (1+B)	Nonaccount balance benefit attributed to service after 2009				
			Principal Addition	Earnings: G at prior year-end × (1+B)	Benefit payments in year	Account balance at 12/31	Attribution to tax year under standard method: F+G–G at prior year-end
A	B	C	D	E	F	G	H
2009		$600,000					
2010	5.84%	635,040	$50,000	$0	$0	$50,000	$50,000
2011	5.44%	669,586	52,500	2,720	0	105,220	55,220
2012	4.36%	698,780	55,100	4,588	0	164,908	59,688
2013	4.08%	727,290	57,900	6,728	0	229,536	64,628
2014	4.50%	760,018	60,800	10,329	0	300,665	71,129
2015	5.00%	798,019	63,800	15,033	0	379,498	78,833
2016	5.25%	839,915	67,000	19,924	0	466,422	86,924
2017	5.75%	888,210	70,400	26,819	563,641	0	97,219
Total amount attributed to 2010-2017 tax years							$563,641

2. Attribution for Non-Service Years Under Account Balance Plans

As noted above, under the standard method for attributing DDR under account balance plans, net increases in account balances (taking into account withdrawals) are DDR that is attributed to the taxable year of that increase, and net decreases reduce the DDR otherwise attributable to that taxable year. This formula only applies, however, if the Applicable Individual actually provides services in that taxable year, as the $500,000 cap applies with respect to each year in which the DDR is earned. The Preamble requested comments on how balance increases and decreases should be attributed under standard method attribution during years in which the Applicable Individual does not provide services.

Proposal

We recommend that, for CHIPs adopting the standard attribution method for account balance plans, increases and decreases in an account balance plan in taxable years where the Applicable Individual does not provide services be attributed ratably, in daily portions, to the period beginning with the first contribution to the account balance plan and ending with the date of the Applicable Individual's separation from service.

Discussion

We note at the outset that the problem of attributing increases and decreases in account balance plans in years in which the Applicable Individual is not a service provider would not apply to CHIPs that have adopted the alternative method, which traces back all earnings and losses back to the taxable year of the increase in principal to which those earnings and losses are attributable. Rather, it is an artifact of an otherwise

sensible rule clearly crafted to enhance administrability of what could otherwise become an unmanageable recordkeeping system.

To ease administration, we suggest that attributing increases and decreases in account balance plans that occur during non-service years be effected by simply spreading them out ratably over the period during which the Applicable Individual maintained an account balance plan and provided services. As described below, this kind of ratable "daily portions" attribution is used in the Proposed Regulations for other types of DDR,[58] and would generally achieve a result similar to that under the alternative method—attribution of the gains and losses back to prior periods of service.

The period should begin on the date on which the Applicable Individual opened the account balance plan and end on the date of the Applicable Individual's separation from service, which dates are both likely to be easily determined and accessible with respect to any Applicable Individual. In the case of an Applicable Individual with prior multiple multi-year breaks in service, it may be necessary to combine periods—the first period may begin on the date of the opening of the account balance plan and end on the date of the separation from service, the next period on the date of resumption of service and end on the second separation from service, and so forth.

This attribution method would arrive at different results than the alternative method to the extent that contributions to account balance plans were uneven—where contributions were front-loaded, or higher contributions were made toward the end of a service period, the result would differ. One could surmise an alternative rule that would weight attribution based on the average account balance (on a daily or annual basis), perhaps even taking into account present-value calculations. Such an approach, however, would be inconsistent with the policy of the standard method for attribution under account balance plans, which is to make administration easier, and for relatively little benefit.[59]

3. Account Balance Plan Attribution Consistency Following Corporate Transactions

As noted above, while the Proposed Regulations permit CHIPs to adopt either the standard or alternative method for attributing DDR under account balance plans, the Account Balance Consistency Rule also requires that the CHIP use the same method for

[58] It is used, for example, to attribute certain forms of DDR subject to a substantial risk of forfeiture, discussed in Part IV.D.6, and to equity-based DDR, discussed in Part IV.D.7, as well as to involuntary separation pay under Prop. Treas. Reg. § 1.162-31(d)(6)

[59] We acknowledge that this rule could conceivably be abused by an employer adopting an account balance plan years in advance of significant contributions, in order to spread attribution of post-separation earnings over more days in more years. However, such a technique could backfire in the event of a decrease in the account balance, as our proposed rule would cause losses to reduce DDR across years as well, rather than concentrating them in a year where total compensation was at or above the Section 162(m)(6) limit..

all its account balance plans for all taxable years. In the Preamble, Treasury and the IRS requested comments on circumstances in which it may be permissible for a CHIP to change its attribution method, such as following a Corporate Transaction.[60]

Proposal

Although we do not recommend a particular rule for such a circumstance, we recommend that transitional rules following a Corporate Transaction not require a retroactive change from the standard to the alternative method.

Discussion

We note that we are not addressing the circumstances in which a CHIP may be permitted to elect to change its method of attribution for account balance plans, whether following a Corporate Transaction or otherwise. We are concerned, however, that the Account Balance Consistency Rule could require a CHIP, following a Corporate Transaction, to adopt the same attribution method as its counterparty. For example, if two CHIPs, one employing the standard method and the other employing the alternative method, were to merge, then after the merger, if the combined CHIP were to employ different methodologies for the plans it inherits from its predecessors, it would be in breach of the Account Balance Consistency Rule.

A number of possible transitional rules could apply in such a case. For example, the plans previously governed by each method could be "grandfathered" and continue to be governed by the prior method, so long as new participants and new plans were consistently governed by one method or another. Alternatively, the applicable rule might provide that the new combined CHIP would be permitted to elect to convert its plans retroactively to either method. There could even be a hybrid rule pursuant to which plans under the alternative method transition into the standard method in the future, while maintaining an alternative-method "sub-account" similar to that described in Part IV.D.1. Ultimately, we have been unable to come to a conclusion as to which transitional rule would best fit taxpayers' and the IRS's respective needs (indeed, one additional solution would simply be to permit taxpayers to continue to use any reasonable method).

While we do not, therefore, suggest any particular transitional rule, we do feel strongly that the least desirable set of rules would be one of rules under which plans that were previously on the standard method would be required to retroactively convert to the alternative method.[61] As we note above,[62] the alternative method is likely to require an

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[60] Other issues relating to Corporate Transactions are described in Part IV.A.

[61] For example, under one possible transitional rule, if two CHIPs join the same Aggregated Group, the smaller CHIP, or the CHIP maintaining the smaller account balance plan (measured by principal amount) would be required to adopt the method elected by the other CHIP. In any case where the larger CHIP used the alternative method, the smaller CHIP would then be required to switch from the traditional to the alternative method, entailing the difficulties described below.

[62] See Part IV.D.1.

extensive set of recordkeeping in order to track each principal contribution and the subsequent earnings and losses derived therefrom. This would be a considerable undertaking even on a current basis, as contributions are made and earnings and losses accrue. Retroactive conversion from the standard to alternative method would require a still greater undertaking. To retroactively convert a plan that previously employed the standard method (which requires calculating only the overall changes in account balances for each year) to the alternative method would require a complete reconstruction of a considerable amount of data from prior periods—not just overall changes in investments, but determining each contribution, and then relating all subsequent changes in balances back to each contribution (and, by extension, the year in which that contribution was made). All this would need to happen (presumably) shortly after a Corporate Transaction, when administrative resources are already strained in the ordinary course of merging two previously independent entities. Thus, we suggest that the rule in final regulations preserve optionality and transitional rules so as never to force a CHIP to transition plans from the standard to alternative method (though we have no objection to a rule that would permit it to do so).

4. Attribution Rules for Nonaccount Balance Plans

For nonaccount balance plans, the Proposed Regulations provide only one method of attributing DDR to taxable years. The amount attributed to a taxable year equals the present value of future benefits to which the Applicable Individual has a legally binding right at taxable year's end,[63] plus any benefit payments during the taxable year, minus the present value of future benefits to which the individual had a legally binding right at the prior taxable year's end. Present values are determined under FICA tax rules. Amounts attributed to taxable years when no services are performed must be reattributed to service years during which a legally binding right to the compensation exists.[64] For plans that pay annuities or installments, the present value of future benefits must be recalculated at the end of each taxable year in which benefits are actually paid.

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[63] Under the Proposed Regulations, an "applicable individual does not have a legally binding right to remuneration if the remuneration may be reduced unilaterally or eliminated by the covered health insurance provider or other person after the services creating the right to the remuneration have been performed." See Prop. Treas. Reg. § 1.162-31(d)(2); cf. Treas. Reg. § 1.409A-1(b)(1). Perhaps counterintuitively for lawyers who do not practice in the employee benefits and Section 409A areas, an employee may have a "legally binding right" to unvested compensation, so long as vesting is contingent on a nondiscretionary, objective term of the plan. *Id.*

[64] As with the reattribution of changes in account balances during non-service years under the standard method of attribution for account balance plan DDR, see Part IV.D.2, the method to be used for this reattribution of nonaccount balance DDR is unclear. There is no rule prescribed in the Proposed Regulations. The Preamble both requests comments on the appropriate method to be use and indicates that, until a method is prescribed, taxpayers may use any reasonable method. See Preamble at 19,956. As we note below, our proposal, in simplifying the attribution of nonaccount balance DDR generally, also has the helpful effect of avoiding this specific reattribution problem altogether.

Proposal

We recommend that the final rules provide an alternative DDR attribution method for nonaccount balance plans under which each benefit payment is attributed to taxable years (and to the grandfathered amount, if applicable) in proportion to the increase in the formula benefit during the taxable year.

Discussion

The calculations required by the Proposed Regulations to attribute DDR under a nonaccount balance plan do not work well for most nonaccount balance plans, including defined benefit ("DB") supplemental retirement plans that often pay lifetime benefits. For a DB plan, the rules in application are extremely complex and burdensome, especially when benefits are paid as a lifetime annuity. Our proposed alternative rule would be much easier to implement and also produces more rational results. The next example illustrates the calculations required under the Proposed Regulations and our recommended alternative.

Example – attribution method in proposed regulations

CHIP B, a calendar-year taxpayer, provides a DB supplemental executive retirement plan ("SERP") benefit to Anna when she is hired on January 1, 2014, at age 45. Anna is immediately vested in the SERP benefit: an annual single life annuity of $5,000 multiplied by her years of service, starting December 31, 2023, when Anna is age 55, or the December 31 after Anna separates from service, if later. The benefit is forfeited if Anna dies before payments start.

Anna separates from service December 31, 2018, having completed five years of service, which entitles her to an annual benefit of $25,000. B makes the first $25,000 annuity payment to Anna on December 31, 2023. To determine how much of the payment can be deducted, B needs to attribute it to Anna's years of service based on the change in present value over each taxable year. B uses a 5.5% interest rate and the Section 417(e) mortality table, which are reasonable at December 31, 2023, to determine the present value of future payments at the end of each year during Anna's period of service (i.e., 2014–2018).[65] B also calculates the present value of future payments at December 31, 2023 (excluding the $25,000 paid on December 31, 2023). B doesn't need to calculate present values at 2019–2022 year-end since the entire increase in value from December 31, 2018, through December 31, 2023, will have to be reattributed to Anna's service years. These present values are shown in Column E of the table below.

Next, B calculates the increase in present value during each service year as the present value at year-end, minus the present value at prior year-end, as shown in Column F. B also calculates the increase in present value from the end of the last taxable

[65] We use the 2013 Section 417(e) mortality table in these illustrations since tables for later years have not been published yet.

year Anna provided services (December 31, 2018) to the end of the taxable year when the first payment is made (i.e., December 31, 2023), as the present value of future payments at December 31, 2023, plus the 2023 payment, minus the present value of future payments at December 31, 2018 ($328,477 + $25,000 – $267,946 = $85,531). This amount must be reattributed to Anna's service years 2014–2018. Because the Proposed Regulations do not prescribe how this should be done, B decides to reattribute the $85,531 in proportion to the amount attributed to each service year under the prescribed attribution formula, as shown in Column H. (We do not mean to suggest that there are not other possible reasonable attribution methods that B could use here.) The total amount attributed to each service year is shown in Column I.

Year	Age at Dec. 31	Service	Accrued Benefit starting at 55: B × $5,000	Benefit paid Dec. 31	Present value of future payments	Amount attributed to service year: E – E for prior year	Amount attributed to nonservice year: D + $E_{2023} – E_{2018}$	G reattributed to service years: F × 85,531 / 267,946	Total attributed to service year: F+H
	A	B	C	D	E	F	G	H	I
2014	46	1	$5,000		$43,080	$43,080		$13,752	$56,832
2015	47	2	10,000		90,985	47,905		15,292	63,197
2016	48	3	15,000		144,126	53,141		16,963	70,104
2017	49	4	20,000		202,951	58,825		18,777	77,602
2018	50	5	25,000		267,946	64,995		20,747	85,742
2023	55			25,000	328,477		$85,531		
Total						**$267,946**	**$85,531**	**$85,531**	**$353,477**

Finally, B applies the first-in, first-out rule to determine that the $25,000 payment is attributed to 2014.

B must go through this process again when the next payment is made on December 31, 2024. Market interest rates rose throughout 2024, and B uses a reasonable interest rate of 6.5% and the Section 417(e) mortality table to calculate the $290,314 present value of Anna's future benefits at December 31, 2024. B next determines the amount attributed to 2024 as the present value of future payments at December 31, 2024, plus the 2024 payment, minus the present value of future payments at December 31, 2023, or $290,314 + $25,000 – $328,477 = $(13,163). This loss must be reattributed to Anna's service years. Pending guidance from IRS, B may use any reasonable method that is consistent with the approach used in prior years. B decides to reattribute the change in present value after payments start in proportion to the remaining amount attributed to each service at the prior payment date, after reflecting the prior year's payment under the first-in, first-out rule. Ultimately, B determines that the 2024 payment is attributed to Anna's service in 2014, as detailed in the next table.

Attribution of 2024 payment	Amount attributed to service years					Total
	2014	2015	2016	2017	2018	
1. Attribution to service years at Dec. 31, 2023, before reflecting $25,000 payment: column I from prior table	$56,832	$63,197	$70,104	$77,602	$85,742	$353,477
2. First-in, first-out attribution of 2023 payment	25,000					25,000
3. Attribution at Dec. 31, 2023, after reflecting 2023 payment: (1.) – (2.)	31,832	63,197	70,104	77,602	85,742	328,477
4. Present value of future payments at Dec. 31, 2024						290,314
5. Change in present value attributed to 2024: (4.) + $25,000 – (3.)						(13,163)
6. Reattribution of (5.) over service years in proportion to (3.): $(13,163) x (3.) / $328,477	(1,276)	(2,532)	(2,809)	(3,110)	(3,436)	(13,163)
7. Attribution to service years at Dec. 31, 2024, before reflecting $25,000 payment: (3.) + (6.)	30,556	60,665	67,295	74,492	82,306	315,314
8. First-in, first-out attribution of 2024 payment	**$25,000**					

B goes through this attribution exercise again in 2025. Market interest rates have fallen back, so B uses a reasonable interest rate of 6.0% and the Section 417(e) mortality table to determine that the present value of Anna's future benefits at December 31, 2025, is $300,842. As in 2024, B determines the amount attributed to 2025 as the present value of future payments at December 31, 2025, plus the 2025 payment, minus the present value of future payments at December 31, 2024, or $300,842 + $25,000 – $290,314 = $35,528. B reattributes this amount to Anna's service years using the same method that was used in 2024, and then applies the first-in, first-out rule to determine that $6,236 is attributed to 2014 and $18,764 to 2015. The next table details the calculations.

Attribution of 2025 payment	Amount attributed to service years					Total
	2014	2015	2016	2017	2018	
1. Amount attributed to service years at Dec. 31, 2024, after reflecting 2024 payment: (7.) – (8.) from prior table	$5,556	$60,665	$67,295	$74,492	$82,306	$290,314
2. Present value of future payments at Dec. 31, 2025						300,842
3. Change in present value attributed to 2025: (2.) + $25,000 – (1.)						35,528
4. Reattribution of (3.) over service years in proportion to (1.): $35,528 x (1.) / $290,314	680	7,424	8,235	9,116	10,073	35,528
5. Attribution to service years at Dec. 31, 2025, before reflecting $25,000 payment: (1.) + (4.)	6,236	68,089	75,530	83,608	92,379	325,842
6. First-in, first-out attribution of 2025 payment	**$6,236**	**$18,764**				**$25,000**

The proposed rules would require B to repeat this burdensome attribution process each year until payments stop at Anna's death. Assuming Anna dies in 2043 after receiving 20 payments and we make the simplifying assumption that 6.0% interest and Section 417(e) mortality remain reasonable in all future years, the attribution of her total $500,000 in benefit payments would be as follows:

	Amount of payment attributed to Anna's service in					
Payment date	**2014**	**2015**	**2016**	**2017**	**2018**	**Total**
December 31, 2023	$25,000	$0	$0	$0	$0	$25,000
December 31, 2024	25,000	0	0	0	0	25,000
December 31, 2025	6,236	18,764	0	0	0	25,000
December 31, 2026	0	25,000	0	0	0	25,000
December 31, 2027	0	25,000	0	0	0	25,000
December 31, 2028	0	4,677	20,323	0	0	25,000
December 31, 2029	0	0	25,000	0	0	25,000
December 31, 2030	0	0	25,000	0	0	25,000
December 31, 2031	0	0	25,000	0	0	25,000
December 31, 2032	0	0	6,998	18,002	0	25,000
December 31, 2033	0	0	0	25,000	0	25,000
December 31, 2034	0	0	0	25,000	0	25,000
December 31, 2035	0	0	0	25,000	0	25,000
December 31, 2036	0	0	0	25,000	0	25,000
December 31, 2037	0	0	0	25,000	0	25,000
December 31, 2038	0	0	0	19,522	5,478	25,000
December 31, 2039	0	0	0	0	25,000	25,000
December 31, 2040	0	0	0	0	25,000	25,000
December 31, 2041	0	0	0	0	25,000	25,000
December 31, 2042	0	0	0	0	25,000	25,000
Total	**$56,236**	**$73,441**	**$102,322**	**$162,524**	**$105,478**	**$500,000**

Note that if Anna had died in 2033 after receiving 10 annual payments totaling $250,000, the attribution of those total payments to her service years (the total of the first 10 rows of the table above) would be:

	Amount of payment attributed to Anna's service in					
	2014	**2015**	**2016**	**2017**	**2018**	**Total**
Total attributed	$56,236	$73,441	$102,322	$18,002	$0	$250,000

In this case, none of her SERP benefit payments would be attributed to her 2018 service, even though her SERP benefit would have been only $20,000 per year and she would have received only $200,000 in total payments if she had not worked in 2018. On the flip side, if Anna lived another 20 years to age 95, receiving an additional $500,000, all payments on and after December 31, 2039, would be attributed to her service in 2018, resulting in a disproportionate total of $605,478 attributed to 2018.

Example – recommended alternative attribution method

A less burdensome method would be to attribute each benefit payment to service years in proportion to the increase in the participant's plan formula benefit during the year. In the preceding example, this alternative method would attribute $5,000 of each payment to each taxable year from 2014 through 2018. The attribution of the total

$500,000 paid to Anna starting December 31, 2023 and ending December 31, 2042 would be as follows:

	Amount of payment attributed to Anna's service in					
Payment date	**2014**	**2015**	**2016**	**2017**	**2018**	**Total**
December 31, 2023	$5,000	$5,000	$5,000	$5,000	$5,000	$25,000
December 31, 2024	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2025	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2026	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2027	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2028	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2029	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2030	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2031	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2032	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2033	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2034	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2035	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2036	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2037	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2038	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2039	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2040	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2041	5,000	5,000	5,000	5,000	5,000	25,000
December 31, 2042	5,000	5,000	5,000	5,000	5,000	25,000
Total	**$100,000**	**$100,000**	**$100,000**	**$100,000**	**$100,000**	**$500,000**

Regardless of Anna's age at death, a portion of the total payments received would be attributed to each service year, according to the growth in her plan formula benefit over the year.

This method is analogous to the alternative method for account balance plans in that over the total payout period it attributes the change in present value of the benefit earned in a particular taxable year to the taxable year the benefit was earned. But instead of applying a first-in, first-out rule, each payment is spread among the service years in which plan benefits were earned.

This suggested alternative method for nonaccount balance plans offers several advantages over the method in the Proposed Regulations:

- Present value calculations are not needed — each benefit payment is directly attributed to taxable years according to the plan's benefit formula.

- Changes in the present value of future benefits that occur during non-service years do not need to be reattributed to service years.

- Financial reporting of deferred tax assets is greatly simplified. Because the deductibility of even fixed future payments would no longer be subject to interest rate risk (as changes in discount rates affect the present value of those payment streams), the value of deferred tax assets associated with those deductions would likewise be fixed.

- The results make sense. In the preceding example, if Anna had terminated after just one year, she would be entitled to a benefit of $5,000 per year starting December 31, 2023, and each payment would be attributed to Anna's service in B's 2014 taxable year. There is no reason to change this attribution merely because Anna continues working, as would happen under the method in the Proposed Regulations.

Our recommended alternative is similar to Example 2 in Prop. Treas. Reg. § 1.162-31(e)(3), which applies this method without explanation. Under the facts in this example, in 2016, the employer grants an employee the right to receive two payments upon separation from service: $120,000 in the year of separation and $100,000 the next year. This arrangement clearly meets the definition of a nonaccount balance plan under the 409A regulations.[66] But the example does not follow the attribution rule for nonaccount balance plans, under which the present value of the two payments at December 31, 2016, would be attributed to the 2016 taxable year, and the increase in present value due to the passage of time in each subsequent year would be attributed to that year. (Example 5 in Prop. Treas. Reg. § 1.162-31(d)(9) applies this present-value-based attribution method to a similar set of facts, except the benefit is paid in a single lump sum at a specified date rather than two installments triggered by separation from service.) Instead, Example 2 attributes the entire amount to 2016, which is the result that would be obtained using our recommended alternative method. We are unsure whether this was in error, or whether there is a reason the present value method was not adopted in Example 2. We believe that the example should be corrected or clarified, should our proposal (the adoption of which would also obviate the confusion) not be adopted.

5. Grandfathered Amounts Under Nonaccount Balance Plans

It is unclear how CHIPs are supposed to apply the grandfathered amount determined under the Proposed Regulations — which is a present value, not a benefit amount — to a nonaccount balance DDR that takes the form of installment or annuity payments.[67]

[66] See Treas. Reg. §§ 1.409A-1(c)(2)(i)(C), 31.3121(v)(2)-1(c)(2)(i).

[67] Grandfathering under Section 162(m)(6) is discussed generally in Part III.B. Other problems relating to grandfathering of DDR are discussed in Parts IV.D.1 and IV.D.8.

Proposal

We recommend that our suggested alternative attribution method for nonaccount balance plans described above be applied to determine the grandfathered amount of nonaccount balance DDR under any payment form: simply treat a portion of each benefit payment as grandfathered.

Alternatively, if our proposal is not adopted, final regulations should provide examples that clearly show how the grandfathered amount is determined and applied under a nonqualified defined benefit plan paying lifetime annuity benefits.

Discussion

Under the recommended alternative, a portion of each benefit payment is grandfathered. The grandfathered portion is equal to the benefit the Applicable Individual actually becomes entitled to, in the form and at the time actually paid, but determined under plan terms in effect on the last day of the CHIP's last taxable year beginning before 2010, without regard to any service after that date or any other events affecting the amount of or entitlement to benefits (other than the Applicable Individual's time and form-of-payment election) and ignoring any substantial risk of forfeiture. Our proposed approach is consistent with the general intent of the Proposed Regulations, and can be applied directly without the need for present value calculations.

6. Substantial Risk of Forfeiture and Account Balance, Nonaccount Balance and Residual Rule Plans

If DDR attributable under the rules for account balance plans, nonaccount balance plans or other legally binding rights (that is, the residual rule) is subject to a substantial risk of forfeiture, a multistep reattribution rule must be followed that includes reattributing all DDR attributed to periods when there was a substantial risk of forfeiture on a daily pro rata basis over the period beginning on the date the Applicable Individual first has a legally binding right to the remuneration and ending on the date the substantial risk of forfeiture lapses (the "Reattribution Rule").

Proposal

We recommend that the final rules make the Reattribution Rule optional rather than mandatory. While pro rata attribution is a helpful simplification for plans that pay benefits immediately upon vesting, it unnecessarily complicates administration of plans that do not. CHIPs should be allowed to determine plan-by-plan whether to apply this rule. In addition, for those electing the Reattribution Rule, the rule should clarify whether the day the risk of forfeiture lapses is counted in the vesting period or not.

Discussion

Under the Proposed Regulations, if participants are not immediately vested in their account balances, a multistep process must be followed:

- Step 1: the DDR is attributed to taxable years under the rules for account balance plans (using either the standard or alternative method, as elected by the sponsor), nonaccount balance plans, or legally binding rights, as applicable.

- Step 2: if the substantial risk of forfeiture lapses for any reason (including satisfaction of age or service requirements, death, disability, involuntary termination, or at the employer's discretion) on a day other than the last day of the CHIP's taxable year, the amount attributed to that taxable year must be divided on a daily pro rata basis into a portion that includes the vesting period (based on the number of days the remuneration was subject to a substantial risk of forfeiture) and the portion that does not include the vesting period.

- Step 3: all amounts that are attributed to periods when there was a substantial risk of forfeiture (including those attributed to the vesting period in Step 2) are attributed on a daily pro rata basis over the period beginning on the date the Applicable Individual first has a legally binding right to the remuneration and ending on the date the substantial risk of forfeiture lapses.

For DDR that is paid (and deductible) immediately upon vesting, pro rata attribution over the vesting period is a useful shortcut. There is no need to attribute benefits under the rules for account balance plans, nonaccount balance plans, or legally binding rights because the attribution will be overridden by daily pro rata attribution. For other plan designs, however, this three-step process adds unnecessary complexity as illustrated in the following example.

> Example: CHIP X, a calendar-year taxpayer, sponsors a nonqualified account balance plan. Roger becomes a participant on January 1, 2014. X credits $50,000 to Roger's account at the end of each taxable year through his retirement on December 31, 2020. Earnings (and losses) are credited to the account annually at year-end and are based on the rate of return of a predetermined investment. If Roger separates from service on or after his 55th birthday on September 23, 2020, the account balance will be paid to him the following January 1. But the account balance is forfeited if he separates before that date. Roger separates from service in December 2020 and receives the account balance January 1, 2021. The table below shows how Roger's account balance changes over his period of service and the attribution of the January 1, 2021 payment to his taxable years of service under the standard method.

Year	Account balance at Jan. 1	Principal addition	Rate of return	Earnings (losses)	Benefit payments in year	Account balance at Dec. 31	DDR attributed to year: E + F - A
	A	B	C	D	E	F	G
2014	$0	$50,000	N/A	$0	$0	$50,000	$50,000
2015	50,000	50,000	10%	5,000	0	105,000	55,000
2016	105,000	50,000	18%	18,900	0	173,900	68,900
2017	173,900	50,000	7%	12,173	0	236,073	62,173
2018	236,073	50,000	(25%)	(59,018)	0	227,055	(9,018)
2019	227,055	50,000	14%	31,788	0	308,843	81,788
2020	308,843	50,000	3%	9,265	0	368,108	59,265
2021	368,108	0	N/A	0	368,108	0	0
Total							$368,108

X must divide the $59,265 attributed to 2020 into the portion that includes the vesting period (January 1 – September 23) and the portion that doesn't (September 24 – December 31). The portion that includes the vesting period is $43,190 ($59,265 × 266 / 365), and the remaining $16,075 is the portion that does not include the vesting period.

In this example, we have assumed the September 23 vesting date is counted in the vesting period, but the leap day, February 29, is ignored, resulting in a 266-day vesting period. For two reasons, it is not entirely clear from the Proposed Regulations that this is the correct treatment.

First, Section 1.162-31(d)(1)(v) of the Proposed Regulations provides that all years are treated as having 365 days, but does not indicate how to calculate the number of days in a leap year. We recommend that Final Regulations include one or more examples that clarify that that February 29th is ignored (or treated as the same day as February 28) in any case where a leap year is treated as having 365 days.

Second, it is not clear whether the vesting date itself counts as within or without either the vesting period or the non-vesting period. For example, if a benefit is forfeited if the employee separates from service before April 1, 2015, and nonforfeitable if the employee separates on or after April 1, 2015, is April 1 counted in the 2015 vesting period (resulting in a 91-day vesting period)? Or is the 2015 vesting period only the 90-day period from January 1 through and including March 31, during which the benefit could be forfeited? We believe the simplest solution would be, in all cases, to treat the vesting date itself as within the vesting period.

Next, X combines the $43,190 from 2020 that includes the vesting period with amounts attributed to 2014–2019, totaling $352,033. This total must be reattributed on a daily pro rata basis over the vesting period from January 1, 2014, to September 23, 2020. The Proposed Regulations allow A to treat each full year as having 365 days, so the total number of days in this period is 2,456, determined as (6 × 365) + 266. The amount attributed to each of the full years is $52,318 ($352,033 × 365 / 2,456), and the remaining $38,125 ($352,033 – (6 × $52,318)) is attributed to January 1 – September 23, 2020. The table below summarizes the reattribution results.

Year	DDR attributed to pre-vesting service under standard method	DDR attributed to post-vesting service under standard method	Daily pro rata reattribution of column A total to vesting period	Total DDR attributed to year: B + C
	A	B	C	D
2014	$50,000	$0	$52,318	$52,318
2015	55,000	0	52,318	52,318
2016	68,900	0	52,318	52,318
2017	62,173	0	52,318	52,318
2018	(9,018)	0	52,318	52,318
2019	81,788	0	52,318	52,318
2020	43,072	16,075	38,125	54,200
Total	**$351,915**	**$16,075**	**$352,033**	**$368,108**

7. Attribution of Equity-Based DDR: Generally

The pro rata daily portions rule in the case of DDR subject to a substantial risk of forfeiture described above applies only to DDR under account balance plans, nonaccount balance plans and the residual rule, and therefore appears to exclude equity-based compensation. Instead, the rules governing attribution of most equity-based compensation appear to apply regardless of whether they were subject to a substantial risk of forfeiture or not.

Proposal

We recommend that, in addition to the daily pro rata attribution rules provided in the Proposed Regulations, CHIPs should have the option to attribute equity compensation entirely to the year in which the equity compensation vests or, in the case of stock rights,[68] is exercised, or, in the case of RSUs, is includible in income of the Applicable Individual, subject to the proposed modification discussed below following corporate transactions.

Discussion

Under the Proposed Regulations, remuneration that takes the form of equity-based compensation is attributed evenly, in daily pro rata portions, to services provided during a relevant period (the "Attribution Period"). In the case of stock rights, the Attribution Period is from the date of grant to the date of exercise.[69] In the case of restricted stock for which the Applicable Individual did not make a Section 83(b) election, the Attribution Period begins on the date of creation of a legally binding right to the amount and ends on the earlier of (i) the lapse of substantial risk of forfeiture or (ii) the date on which the

[68] "Stock rights" as used here has the meaning given such term in Treas. Reg. § 1.409A-1(*l*), meaning a nonqualified stock option or stock appreciation right.

[69] Prop. Treas. Reg. § 1.162-31(d)(5)(i).

stock becomes transferable as defined in Treas. Reg. Section 1.83-3(d).[70] In addition, the Attribution Period for RSUs starts on the date of creation of the legally binding right and ends on the date of payment or when the compensation would be deemed includible in gross income.[71] In each case, only days when the Applicable Individual remains a service provider with the CHIP are included in the pro rata calculation.

In the case of equity awards the vesting period for which is based purely on length of service, such as the in the examples in the Proposed Regulations illustrating the operation of the restricted stock and RSU rules,[72] this extended Attribution Period may be appropriate. Where vesting or exercise are conditioned on meeting performance goals—either personal to the service provider or general to the organization[73]—the compensation may be more properly attributable to services provided in the year in which the goals were met. For example, especially in the private equity context, where equity awards are often not effectively exercisable before a liquidity event, equity compensation may more closely resemble a "deal bonus" for a sale or IPO than a reward for one's entire period of service.

By contrast, a CHIP may attribute remuneration from involuntary separation pay by one of two alternative methods.[74] The CHIP may attribute compensation paid upon involuntary separation from service to the taxable year in which the separation occurs.[75] Alternatively, the CHIP may attribute involuntary separation pay on a daily pro-rata basis across an Attribution Period beginning on the date of creation of the legally binding right to the amount and ending on the date when the involuntary separation occurs.[76] It is not clear why involuntary separation pay has been granted this treatment.[77] To the extent that

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[70]Prop. Treas. Reg. §1.162-31(d)(5)(ii).

[71]Prop. Treas. Reg. § 1.162-31(d)(5)(iii).

[72]See Prop. Treas. Reg. § 1.162-31(d)(9), (exs. 8, 9). Example 8 of Prop. Treas. Reg. § 1.162-31(d)(a) discusses a restricted stock award that vests if the individual continues employment with the company for an additional three-year period. Likewise, in Example 9, an applicable individual receives a grant of RSUs subject to forfeiture if the individual fails to continue to provide substantial services to the CHIP over an additional three-year period. In each case, the CHIP attributes the amount on a daily pro-rata basis over the three-year period preceding vesting.

[73]Cf. Treas. Reg. § 1.409A-1(d)(1) (providing that, to qualify as a substantial risk of forfeiture, "condition[s] related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering)").

[74]Prop. Treas. Reg. § 1.162-31(d)(6).

[75]*Id* .

[76]Prop. Treas. Reg. § 1.162-31(d)(6).

[77] *See also* Prop. Treas. Reg. § 1.162-31(d)(7) (attributing reimbursements or in-kind benefits paid in the year in which the Applicable Individual is not a service provider to the first preceding taxable year of the CHIP in which the Applicable Individual was a service provider, rather than to the year in which the reimbursed payment was made or the in-kind benefit was received).

it is because the circumstances giving rise to involuntary separation pay are largely outside the control of the service provider, we suggest that this may also be true, at least in some circumstances, for equity-based DDR.[78]

It does not seem appropriate to attribute an award to a taxable year when conditions giving rise to the payment have not been satisfied or are largely outside of the control of the service provider. Exercise or vesting may be conditioned on attaining a certain level of earnings or a stock price and thus may depend on economic conditions, performance of other individuals or other factors outside of control of the Applicable Individual. These conditions more closely resemble the condition of involuntary separation from service, over which the Applicable Individual may not exercise control. We therefore recommend that CHIPs be given a similar choice: to attribute equity compensation ratably over the applicable Attribution Period or to attribute it to the taxable year in which vesting, exercise or inclusion in income occurs.[79]

We note that our proposal could be applied in two principal fashions: plan-by-plan or grant-by-grant. We do not express a view as to which approach is superior. While we suspect that at least some CHIPs may have compensation arrangements sufficiently complex to take advantage of the planning opportunities offered by a grant-by-grant approach, it is not clear whether this benefit outweighs the additional complications of administering such a rule and facilitating such tax planning.

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[78] It is unclear, and we do not take a position on, whether the same rule should apply to account balance plan, nonaccount balance plan and residual DDR. On the one hand, similar to equity-based DDR, the examples in the Proposed Regulations address only situations in which the substantial risk of forfeiture of the other DDR is based solely on longevity of service of the Applicable Individual. *See* Prop. Treas. Reg. § 1.162-31(d)(11), exs. 1–3, 78. Likewise, an Applicable Individual may not control the conditions resulting in the lapse of the substantial risk of forfeiture of these forms of DDR. The rules for involuntary separation pay and the possibility of converting equity-based DDR into account balance plan DDR in a corporate transaction provide further support for permitting CHIPs to elect to attribute non-equity-based DDR entirely to the year of vesting for consistency purposes.

On the other hand, in light of our recommendations, CHIPs may already have other options in attributing non-equity-based DDR; namely, the standard or a form of the alternative method prior to vesting, retaining the same method following vesting, or applying the Reattribution Rule. Unlike with equity-based DDR, CHIPs already would have attributed the compensation prior to vesting and would have planned their compensation techniques accordingly. Reattributing the non-equity-based DDR entirely to the year of vesting may not benefit CHIPs and may result in unwarranted flexibility in deducting the DDR.

[79] By comparison, BlueCross BlueShield Association has recommended another alternative under which CHIPs could elect to attribute DDR from stock rights over a period beginning on the date of grant and ending on the date of vesting, even if exercise occurs at a later date, in order to align the tax deduction with certain accounting standards. *See* Letter from BlueCross BlueShield Association to Daniel I. Werfel, Acting Commissioner, Internal Revenue Service, RE: The $500,000 Deduction Limitation for Remuneration Provided by Certain Health Insurance Providers 5 (Jul. 1, 2013).

8. Attribution of Equity-Based DDR: Following Corporate Transactions

As noted above, under the Proposed Regulations, the daily-portions Attribution Period for RSUs begins on the date the Applicable Individual had a legally binding right to the compensation and ends on the date the RSU is paid. For stock rights, the attribution period begins on the date of grant and ends on the date of exercise. Although we believe that these are generally sensible Attribution Periods for these forms of DDR, in the case of Corporate Transactions, they may not have an appropriate ending date.

Proposal

We recommend that, where stock rights and RSUs vest upon a Corporate Transaction, CHIPs should have the option to attribute income based on the same reattribution rule applicable to account balance plans, nonaccount balance plans and residual DDR, and have the option, as discussed above, to attribute the income entirely to the year of vesting.

Discussion

In Corporate Transactions, the treatment of unvested stock rights and RSUs can vary—although vesting is frequently accelerated, they may not be immediately cashed out. In such cases, while the substantial risk of forfeiture on the stock right or RSU is lifted, it is not exercisable or paid out until the date it would otherwise have been under its original terms, a date which could still be several years away. Instead, the value of these instruments is rolled over into equivalent instruments determined with reference to the stock of the acquiror.

Under the rule in the Proposed Regulations, however, pre-transaction appreciation in this vested DDR will continue to be attributed to post-transaction periods. This may unnecessarily complicate the compensation arrangements of acquirors, which may want to devise new compensation packages for its new employees without having to worry about the extent to which already vested "legacy" DDR may impact the deductibility of future compensation arrangements. In such a case, acquirors should be permitted to cabin pre-vesting appreciation by opting to apply the Reattribution Rule to these forms of equity DDR in the same way it applies to account balance, nonaccount balance and residual rule DDR.[80] To prevent abuse, this election should be permitted only in the year in which the Corporate Transaction occurs, and should be irrevocable.

The comparison to account balance and nonaccount balance plans may be instructive. For those classes of plan, the IRS and Treasury have apparently determined that the vesting period is a useful proxy for determining the period during which DDR is earned. It is unclear why the IRS and Treasury chose to follow general deductibility principles for attributing equity-based DDR but to depart from such principles with

[80] See Part IV.D.6 for a discussion of the operation of the Reattribution Rule.

respect to the Reattribution Rule.[81] However, to the extent that the IRS and Treasury chose to apply a different rationale for reattributing account balance plan, nonaccount balance plan and residual DDR, we believe that this principle should extend to equity-based remuneration as well. The parallel is especially apparent in cases where vested equity-based compensation is converted into the economic equivalent of an account balance plan.

As we note above, the Reattribution Rule may not be appropriate in all contexts, and we suggest that taxpayers have the ability to opt out of it. Likewise, in the case of a Corporate Transaction, we believe that acquirors ought to have the option to attribute pre-acquisition appreciation in stock rights and RSUs to pre-vesting periods.

Consistent with our suggestion in Part IV.D.7, we recommend that, in the event the Reattribution Rule is extended to equity-based DDR, CHIPs similarly should be permitted to attribute the DDR from stock rights or RSUs entirely to the year of vesting. As we noted above, the rationale for the proposed choice-of-attribution rule for equity-based DDR especially may be relevant in the transactional context, where at least part of the equity-based DDR may constitute a deal bonus or other deal-triggered compensation.

9. Grandfathering of Other DDR Categories

The Proposed Regulations address the application of the grandfather rules to account balance plans, nonaccount balance plans, and equity-based remuneration.[82] However, the Proposed Regulations do not specify the application of the grandfather rules to DDR in the form of "involuntary separation pay," "reimbursements," and "split-dollar life insurance," which are types of remuneration also specifically discussed under the general service attribution rules in the Proposed Regulations.

Proposal

We recommend that the final regulations clarify the application of the grandfather rules to DDR in the form of "involuntary separation pay," "reimbursements," and "split-dollar life insurance." Specifically, the final regulations should provide that those amounts are attributed based on the attribution rules generally applicable to each form of DDR, except that any "substantial risk of forfeiture" is disregarded.

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[81] We speculate that the IRS and Treasury, in issuing the proposed reattribution rule, may have looked to the FICA rules setting forth the later of the year of performance of services or of vesting as the time for taking certain nonqualified deferred compensation plan remuneration into account as wages. *See* I.R.C. § 3121(v)(2)(A); Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii). In contrast, non-equity, nonqualified deferred compensation generally is deductible when paid or includible in income, rather than when vested. See I.R.C. §§ 162(a)(1), 404(a)(5); Temp. Treas. Reg. § 1.404(b)-1T, Q&A 1. We note that the IRS and Treasury cited the latter regulation in explaining the definition of DDR in the Proposed Regulations. *See* Preamble at 19,954.

[82] Grandfathering under Section 162(m)(6) is discussed generally in Part III.B. Other problems relating to grandfathering of DDR are discussed in Parts IV.D.1 and IV.D.5.

Discussion

While the Proposed Regulations address the application of the attribution rules to certain types of plans, certain others are left unaddressed. The final regulations should clarify the application of the grandfather rules to those other types of plans. In keeping with the approach taken with respect to account balance plans, nonaccount balance plans and equity-based remuneration, we believe that grandfathered amounts should be attributed based on the attribution rules generally applicable to each form of DDR, but disregarding any substantial risk of forfeiture.

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