



**STATEMENT OF PAULA A. CALIMAFDE ON BEHALF OF
THE SMALL BUSINESS COUNCIL OF AMERICA**

**BEFORE THE SUBCOMMITTEE ON FINANCE AND TAX
OF THE COMMITTEE ON SMALL BUSINESS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES**

**“PENSION PARITY: ADDRESSING THE INEQUITIES BETWEEN
RETIREMENT PLAN OPTIONS FOR SMALL AND LARGE BUSINESSES**

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**HOW CAN WE INCREASE SMALL BUSINESS
EMPLOYEE COVERAGE?”**

October 24, 2007

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which sponsor retirement plans or advise small businesses which sponsor private retirement plans. These enterprises represent or sponsor well over two hundred thousand qualified retirement plans and welfare plans.

Mr. Chairman and Members of the Committee, I am Paula Calimafde, Chair of the Small Business Council of America (SBCA). I am also a practicing attorney who specializes in retirement plan and employee benefits law. As Chair of the SBCA, I am here to present our view as to how worker coverage can be increased in the small business retirement plan system as well as addressing how to achieve pension parity with larger businesses. At the outset, we would like to thank Chairwoman Bean and Congressman Heller, the other members of this Sub-Committee as well as Chairwoman Velazquez and Congressman Chabot, for examining these important issues.

VOLUNTARY QUALIFIED RETIREMENT PLAN SYSTEM - A MAJOR SUCCESS

More than *19 million* American workers are covered by the small business retirement plan system.¹ Most of these small business employees enjoy generous annual retirement plan

¹ Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 2. Employee Characteristics by Employer Retirement Plan Sponsorship, 2003 at CRS-5. This Table shows that there are approximately 5.4 million employees who work for businesses that sponsor a retirement plan and employ fewer than 10 employees, approximately 4.8 million employees who work for businesses that sponsor a retirement plan and employ between 10 and 24 employees, approximately 9.6 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees and approximately 12.6 million employees who work for businesses that sponsor a retirement plan and employ between 100 and 499 employees. Small business retirement plans are sometimes considered as those with fewer than 500 participants while others use a cut off number of 250 or 100. Obviously, if the cut off number is higher than 100 participants, then the small business retirement plan system covers more than 19 million employees. The actual participation rates in these plans is somewhat lower since not all employees are eligible to participate. Many plans require employees to work a year before becoming eligible and many require employees to work at least 1000 hours a year to be eligible to receive contributions. These numbers are different from those presented in an earlier CRS report. See Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Pension Sponsorship and Participation: Summary of Recent Trends, September 10, 2004, Table 4. Participation in Retirement Plans by Size of Firm at CRS-10. This Table shows that there are approximately 5.8 million employees who work for businesses that sponsor a retirement plan and employ fewer than 25 employees and approximately 6.1 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees. There are approximately 31.5 million employees in companies that sponsor a retirement plan and employ more than 100 workers.

contributions from their employers, often in the range of three to ten percent of compensation. The small business qualified retirement plan system is successful in delivering meaningful retirement benefits for its employees.

This was not always the case. Due to a constant onslaught of legislation and regulation throughout the 80's which cut benefits for owners while simultaneously imposing additional costs and burdens on the company, the small business retirement plan system was stagnant at best. Terminations were up and new plan formation was down. By the beginning of the 90's, it became evident to Congress that if small business retirement plan coverage was to be increased, it was imperative to return stability and clarity to the voluntary qualified retirement plan system. Costs for administration had to once again become reasonable. Companies would have to be able to take actions knowing what the results would be and not be concerned about constant changes in the tax laws and regulations throwing their economic planning into disarray. Due to a series of laws passed throughout the 90's and continuing through the major tax bill in 2001 which included significant reforms for small business, Congress was able to put the system back into balance and small business plan formation has been increasing significantly. It is not an exaggeration to say that Congressional action in the retirement plan area over the last 15 years has saved the small business retirement system which in turn has provided retirement security for millions of small business employees. Recently, Congress made permanent the important pension changes known as EGTRRA – this was a significant event and will go a long way towards buttressing the small business retirement system. These provisions were the culmination of work done by Congress over a number of years in which the ideas and opinions of virtually all affected – employers, large, small, governmental, and non-profit, unions and employee groups – were requested and taken into account in putting the law together. This is why the EGTRRA pension provisions were met with approval by almost all groups affected and have been so successful in achieving their policy goals.

IMPORTANCE OF TAX INCENTIVES IN THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

The sine qua non of small businesses is private ownership with any year end surplus revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and “grow” the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the top-heavy and anti-discrimination rules set forth in the Internal Revenue Code and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for

staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners will forgo the retirement plan option.

SMALL BUSINESS PLANS ALSO ALLOW EMPLOYEES TO SAVE VIA PAYROLL DEDUCTION

Not only do many small business retirement plans provide generous employer contributions (generally a profit sharing contribution) and/or an employer matching contribution, but they also often provide the best way for the employees to save for their retirement. 401(k) plans and SIMPLEs are so effective because employees are able to save for their retirement by having automatic deductions taken from their paychecks which reduces the amount of their taxable income. The money saved by the employees grows tax free inside the plan and the 401(k) plan prevents easy access to the money by the employees so that the funds are able to grow and accumulate for retirement (not true for the SIMPLE see below). Apparently, if an employee can reduce his or her paycheck by the amount of desired savings prior to receiving the cash in hand, the odds are the money will, in fact, be saved rather than spent. The SBCA has heard countless small business employees state how much easier it is to save by payroll deduction than by any other method.

Employer sponsored retirement plans are the most effective method for encouraging savings by low to moderate income workers. According to data collected by the Employee Benefits Research Institute (EBRI), 77.9 percent of workers earning between \$30,000 to \$50,000 who were covered by an employer sponsored 401(k) type plan actually participated in the plan, while only 7.1 percent of “non-covered” workers in the same income level, saved in an individual retirement account. In other words, low to moderate income workers are almost 11 times more likely to save when covered by a workplace retirement plan.² Reasons for this striking disparity include the convenience of payroll deductions since it is much easier to save money that one has never had in hand, the convenience of having investments preselected, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer. Unlike the success of the 401(k) plan and other employer-sponsored retirement plans, the rate of personal savings in this country outside of the retirement plan area (and outside IRAs) is quite low – less than two percent.

HOW MUCH IS COVERAGE LAGGING IN THE SMALL BUSINESS WORLD?

Many small businesses would like to provide retirement plans for their employees and believe that retirement plans aid in attracting and retaining top employees. As we know, however, the retirement plan coverage rate for small businesses lags behind the retirement plan coverage rate of their larger counterparts.

² ASPPA, based on the EBRI data, developed a chart setting this statistic out in graph format which demonstrates far more ably than words how effective the employer-sponsored retirement plan is at promoting savings for all workers.

The actual retirement plan coverage picture may not be as bleak as reported, since qualified retirement plans are not required to cover part-time employees, employees under age 21 or transient employees. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the entire workforce and that percentage of the workforce that is actually eligible to participate in a retirement plan. When these ineligible employees are excluded, the coverage numbers improve. Further, these numbers do not distinguish between start up small businesses and those that are established. Data shows that *one third* of all new small businesses fail within the first two years and *fewer than half* survive more than the first four years.³ This is a significant number of businesses which in all likelihood do not offer any retirement plan coverage (because they are struggling merely to exist) and yet are included in the statistics on low small business plan coverage. Once again, this high death rate of small businesses is a factor that could skew the data dramatically. We are not aware of any data that takes into account the coverage for small business employees working for small businesses that have been in business for five years.

Ten years ago there was an analysis done by the Congressional Research Service that showed that approximately 88% of employees who worked for companies that employed 100 or more employees and sponsored a pension or retirement savings plan actually participated in the plan. Approximately 85% of employees in companies with 25 to 99 employees which sponsored such a plan participated and a slightly lower percentage of employees in firms with fewer than 25 employees participated. We have not been able to find this data updated so do not know if it is still valid. If it is, it illustrates that when a small business sponsors a retirement plan, the employees participate at close to the same levels as in larger companies. Thus, once a small business has chosen to sponsor a retirement plan, meaningful participation results.

TAX CODE REQUIRES MEANINGFUL BENEFITS FOR ALL SMALL BUSINESS EMPLOYEES

As mentioned above, once a small business sponsors a qualified retirement plan, employees frequently receive excellent benefits. In fact, employer contribution levels in small business plans are often higher than those offered by larger entities. For instance, small business plans typically provide contributions for staff employees at levels of three, five, six, seven or even higher percentages of compensation. These high levels of contributions are driven by the desire of the business owners and key employees to receive sufficient contributions for their own retirement benefits. Present laws require that significant contributions be given to the non-key employees in order for the key employees to benefit to any meaningful degree.⁴ These

⁵ The Kiplinger Letter, January 20, 2006, Volume 83, No. 3

⁴ The terms “key” and “non-key” as used here are not referring to the definition set forth in the top-heavy rules in I.R.C. § 416(i). Rather we are referring to “key” employees as those employees that the owners of a small business would deem key to running the business and “non-key” employees as those not essential to the operation of the business. As in all other businesses, the small business owners want to provide sufficient benefits and incentives to keep the key employees satisfied with their current employment so they will not move elsewhere. This problem is particularly acute in that small businesses often serve as the training ground for employees who move on to jobs with larger business entities where they perceive there is greater job security and better benefits.

significant contributions for the staff employees result from the anti-discrimination rules under I.R.C. § 401 and not the top-heavy rules found under I.R.C. § 416. The top-heavy rules today are largely duplicative of the existing non-discrimination rules governing the qualified retirement plan system and have outlived their initial good policy impact.

POLICY CHALLENGE – EASE OF ADMINISTRATION VERSUS RETENTION OF RETIREMENT PLAN MONEY

Small business has made it clear to Congress time and time again that it cannot easily accommodate additional administrative burdens. Unfortunately, qualified retirement plans impose additional burdens by way of required forms and governmental regulations. To deal with this problem, Congress has developed an IRA based “retirement” plan known as the SIMPLE. Unfortunately, the very structure which makes the SIMPLE desirable from the viewpoint of the small business owners also makes it a “lesser” plan from the viewpoint of ensuring retirement income security for retired small business employees.

Congress understands the tension between the simplicity of the SEP or SIMPLE (both of which are IRA based plans) and the advantages afforded by a qualified retirement plan (a trust based plan, such as the 401(k) plan). Small businesses operate lean and mean. They do not accept additional administrative burdens easily. The IRA based plans are almost maintenance-free. The small business simply goes to a bank or a brokerage house and sets up separate IRAs for each eligible employee. The company makes the contribution into the IRAs and then walks away from the accounts. Unfortunately, this low administrative burden comes at a price.

The forced savings feature of a “regular “ qualified retirement plan, such as the 401(k) plan, should not be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Retirement plan money can be removed by written plan loan which cannot exceed the lesser of 50% of the account balance or \$50,000. Retirement plan money can also be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency.

This is in contrast to funds inside an IRA, a SIMPLE or a SEP (the latter two being employer sponsored IRA programs) where the funds can be accessed at any time for any reason. True, funds removed will be subject to a 10% penalty if the employee has not reached age 59 ½ (which is also the case for a hardship distribution from a 401(k) plan), but unfortunately it does not appear that the 10% penalty represents a significant barrier. This is why the SIMPLE IRA starts off with a 25% penalty for the first two years an individual participates in hopes that if a participant can accumulate a little bit he or she will be tempted to leave it alone and watch it grow. There is a distinct difference between complying with the statutory requirements for a loan or hardship distribution, including the requirement of expressly asking the employer for the loan or distribution, and having the power, independent of others, to remove money at whim from one’s own IRA.

Thus, from a national policy viewpoint of preserving retirement assets for retirement,

the SIMPLE plan should only be viewed as a starter plan. It is important, therefore, that all businesses, including the very small, be given incentives to enter the “real” qualified retirement plan system as quickly as possible. The SIMPLE is an IRA program, as is the old SEP plan, and in the long run true retirement security for employees is better served by strengthening qualified retirement plans rather than SIMPLEs and SEPs. This is simply because as mentioned above, employees have a far greater opportunity to remove the money from IRAs, SIMPLEs and SEPs and spend it - the forced savings feature of a qualified retirement plan is not present. It is also because the employees have no investment guidance or preselection of investment vehicles that have been determined to be prudent. Certainly, for start-up companies or micro businesses, a SIMPLE is the best first step into the retirement plan system. Thus, we believe that the "gap" between the 401(k) contribution limits and the SIMPLE contribution limits should be carefully preserved so that the system does not tilt in the wrong direction.

We are aware that some small business groups have asked Congress to change the law so that the IRA based plans mirror the higher contribution limits available in the 401(k) plan arena. We understand that they are hearing the complaints of small business owners who want to make everything as easy as possible. However, we believe that Congress has gotten this right and that if the SIMPLE is made stronger (by increasing the amount of retirement plan contributions allowed to the IRA) that it will be detrimental to new small business 401(k) plan formation. This would be harmful to small business employees because they will lose the ERISA protections inherent in the 401(k) plan, the preselection of investment vehicles and most of all, they will gain the ability to have easy access to the money.

Over the years the data has consistently shown two things – give the money to an employee and they won’t save it – give the money to an employee with easy access and they’ll get to it and spend it. Because the goal is to encourage long-term retirement savings, Congress needs to ensure that the 401(k) continues to be the more attractive plan to employers. Thus, it is critical that Congress maintains the existing proportionate differential between contributions allowed to the SIMPLE and those allowed to a 401(k) plan. ***Because of these vitally important policy reasons, the SBCA is opposed to changes in the law which would make the SIMPLE more attractive to a small business as compared to a 401(k).***

Under current law, a company is not allowed to make contributions to a SIMPLE IRA and contribute to any qualified retirement plan in the same calendar year. This provision is unduly restrictive and hampers the ability of small business to switch from a SIMPLE IRA to a trust-based qualified retirement plan such as a safe-harbor 401(k) plan. Taken literally, this provision would invalidate the SIMPLE IRA for the entire calendar year if the employer, at any time during that calendar year, maintained a qualified retirement plan to which contributions were made (by the employee or employer) or benefits accrued for service in the same calendar year. There does not appear to be a good reason why a SIMPLE plan should be invalidated for the entire year if a small business chooses to switch to a qualified retirement plan (which is therefore a stronger plan for the employee) during the year, as long as the same compensation is not taken into account under both plans.

For example, assume that an employer offers a SIMPLE for calendar year 2007 and notifies employees that it will make 100% matching contributions up to 3% of compensation.

Assume that the employer decides to terminate the SIMPLE as of June 30, 2007, and institute a safe harbor 401(k) plan as of July 1, 2007. The employee will receive at least the same contribution by the employer (if not more) under the new safe harbor 401(k) plan than under the SIMPLE. Moreover, under the 401(k) safe harbor plan, the employee generally has the opportunity to defer more compensation and receive more contributions than under the SIMPLE. Thus, the employee is not harmed and may well be significantly benefitted. *This rule needs to be eliminated.*

IMPORTANCE OF AUTOMATIC ENROLLMENT – A MISSED OPPORTUNITY

In a number of studies, behavioral economists have found that the easier it is for an employee to save, the more likely it is for that employee to do so. While this seems to be axiomatic, it is surprising the extent to which employees do whatever is easiest. For instance, an analysis conducted in 2000 found that workers, particularly low income workers, were far more likely to participate in a 401(k) plan if they were automatically enrolled than when they had to sign up for the plan. The numbers are rather startling: when enrollment was not automatic, 37.4% of all workers overall would sign up for the 401(k) plan, but when enrollment was automatic, the number jumped up to 85.9%. This trend was even more pronounced in workers making less than \$20,000 a year. Without automatic enrollment, 12.5% opted to join the plan, with automatic enrollment, 79.5% chose to participate in the plan.⁵ This makes it clear that the way to encourage and increase savings, particularly for the low and mid-income worker, is to have an employer-sponsored plan, preferably with automatic enrollment and a preselected investment feature.⁶ Interestingly, when these factors are present, employees are willing to save in these plans which effectively “lock up” the funds for long term growth since they are designed to have contributions accumulate and grow tax free until retirement. [As an aside, it is important to note that the funding problems seen in some of the very large defined benefit plans are highly unusual in the small business retirement plan system – this is likely due to the fact that the owners’ retirement savings are also inside the plan so that the funding is adequate and the assets are carefully invested. Thus, not only are the plans highly effective as savings vehicles for the employees and for providing significant employer contributions for the employees, they are also by and large properly funded with the assets prudently invested.]

WORKABLE AUTOMATIC ENROLLMENT 401(K) SAFE HARBOR NEEDED

The automatic enrollment 401(k) safe harbor contained in the Pension Protection Act is doing little to encourage small businesses to offer automatic enrollment. The incentive offered to small businesses to take on the extra administration inherent in auto enrollment by reducing

⁵ Washington Post, April 18, 2005, Private Accounts Make for Hard Sell at A8.

⁶ Id., This article also states that in the same analysis conducted in 2000 that overall 71.2% of all workers kept the default investment option offered by the plan and that 24.8% switched to their own choice. Among workers who made below \$20,000 a year, 89.3% stayed with the default investment option and 8.5% chose to select their own choice.

slightly the costs of the current 401(k) match safe harbor has proven to be an insufficient incentive to encourage small business to adopt it. Small business owners will not spend the money to amend the retirement plan and the summary plan description, provide written communication material explaining the new procedure, add an extra burden to their internal payroll system and add to the external administrative costs of running the plan if the incentive is not worth the expense. We have seen that very few small business employers are willing to take on the extra burdens and costs of the new auto enrollment 401(k) safe harbor. Although the regulations have not been issued yet, at least one IRS representative indicated at a recent ABA Tax meeting that IRS believes that there must be a 60-90 notice period before a company can bring an employee in for auto enrollment (which defeats the goal of getting people used to having the 401(k) contributions taken out with their first paycheck). An IRS representative also said that the rule will apply to every employee who have failed to make an affirmative election - which means if a company wanted to use the auto enrollment safe harbor, it could not limit it to new hires. Many believe that this is the type of policy decision that is making the auto enrollment unworkable. If there is no incentive for the small business to adopt the automatic enrollment, they will stay away from it because of the considerable additional administrative burden and expense imposed. What a lost opportunity!

IRA PAYROLL DEDUCTION

The goal, of course, is to encourage more small businesses to offer retirement plans. A very small company that cannot absorb additional administrative burdens should be encouraged to join the system via the SIMPLE. But the laws should encourage the company to join the “real” qualified retirement system, probably through the 401(k) safe harbor plan, as soon as possible. In other words, even though a small business will probably begin with the SIMPLE as a start up plan, it should be encouraged, primarily by larger contribution limits, to “graduate” to the 401(k) plan as soon as possible. But what about the company that is too small or too unstable to even sponsor a SIMPLE? The SBCA believes that it is possible for an IRA payroll deduction system to be constructed that would not trigger any employer fiduciary liability which might prove helpful in allowing the employees to save by payroll deduction. Of course, the details of such a proposal would be critical so that such a rule should not apply to new start ups or to micro businesses.

THE 401(K) PLAN – MAJOR SUCCESS STORY

The 401(k) plan is a tremendous success story. The excitement generated by this plan in the small business arena is amazing. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much the employer contributes. Employees meet with investment advisors to become educated about investments and the choices under their plan. Very often plan participants have toll-free numbers to call to see how their investments are doing and to determine whether they want to change them. Employees discuss among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown. It is not unusual to even here employees discussing the pros and cons of life cycle funds, balanced funds and asset allocation models! **Truly, it is no exaggeration to say that the 401(k) plan has brought the stock market to the**

average American. There is no question that this is the most well-known and well-liked retirement plan design today.

ERSAs – THE SIMPLIFIED PLAN OF THE FUTURE?

The Administration first proposed Employer Retirement Savings Accounts as part of its Fiscal Year 2004 Revenue Proposals ⁷ in an effort to reduce unnecessary complexity in the qualified retirement plan system. The Administration has continued to propose ERSAs in each of its fiscal year revenue proposals thereafter. In 2005, Representatives Johnson and English introduced H.R. 1161 to add Section 401A to the Internal Revenue Code to provide for ERSAs. On the same day a companion bill was introduced into the Senate (S. 547).

The impetus behind ERSAs is to provide employers with a qualified retirement plan stripped of much of its complexity and the corresponding administrative cost and expense. As set forth in the Administration’s Fiscal Year 2008 Revenue Proposals, “The rules covering employer retirement plans are among the lengthiest and most complicated sections of the Code and associated regulations. The extreme complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general)...Moreover, because employer sponsorship of a retirement plan is voluntary, the complexity discourages many employers from offering a plan at all. This is especially true of the small employers who together employ about two-fifths of American workers...Reducing unnecessary complexity in the employer plan area would save significant compliance costs and would encourage additional coverage and retirement saving.” ⁸

ERSAs are designed to replace several different types of retirement plans, all of which provide some form of employee contribution, some on an after-tax basis, others on a pre-tax basis. The plans that would be changed into ERSAs include 401(k) plans, 403(b) plans, 457(b) plans maintained by a governmental agency, SARSEPs, SIMPLEs (IRA type and 401(k) type) and thrift plans. ERSAs would be subject to the current rules governing 401(k) plans, including the rules governing contributions and distributions. The tax rules governing the contributions and distributions from an ERSA would be identical to the tax treatment of such

⁷ General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals, Department of the Treasury, February, 2003. As originally proposed, the top-heavy rules would be repealed and permitted disparity and cross-testing would no longer be permitted. In addition, the original proposal included (i) a uniform definition of compensation that would include all compensation provided to an employee by the employer for purposes of income tax withholding for which the employer is required to furnish the employee a written statement Form W-2, plus elective deferrals; and (ii) a definition of “highly compensated employee” that would be any employee with compensation for the prior year in excess of the Social Security wage base for that year. These proposed changes were not included in the Administrations Fiscal Year 2005 Revenue Proposals or in each revenue proposal offered by the Administration in each fiscal year thereafter. These proposals were eliminated after Treasury heard from many companies how draconian some of these proposals would be and how they would seriously damage the voluntary retirement plan system. All of the remarks in this paper with respect to ERSAs deal with the proposal as it emerged in 2005 and thereafter and do not apply in any way to the original 2004 proposal, which the SBCA does not support and believes would have greatly damage the retirement plan system for companies large and small.

⁸ General Explanations of the Administration’s Fiscal Year 2008 Revenue Proposals, Department of the Treasury, February, 2007 at 13.

contributions/distributions from the plan as it stood prior to becoming an ERSA. Thus, a pre-tax deferral or a Roth contribution would retain its characteristics after the original plan was changed into an ERSA.

In an effort to simplify the rules requiring contributions to qualified retirement plans not to discriminate in favor of the highly compensated employees (“HCEs”), there would be only one test which an ERSA plan must meet to satisfy the nondiscrimination requirements. (The complicated ACP test and the ADP test would no longer be applicable.) Under an ERSA the contribution percentage for eligible HCEs for the plan year cannot exceed 200% of such percentage for the nonhighly compensated employees (“NHCEs”) if the contribution percentage of the NHCEs did not exceed 6%. If the contribution percentage of the NHCEs exceeded 6 percent, there would be no nondiscrimination test.

In addition, ERSAs offer two safe harbors to avoid the simplified nondiscrimination test. The first safe harbor is met if the employer is required to make contributions to a defined contribution plan on behalf of each NHCE in an amount equal to at least 3% of the employee’s compensation. The second safe harbor sidesteps the nondiscrimination test if the employer makes matching contributions on behalf of each NHCE equal to 50% of the elective deferrals of the NHCE to the extent that such elective deferrals do not exceed 6% of the employee’s compensation or the same type of alternative formula match allowed under the current 401(k) safe harbor rules.

In order to allow small employers to provide retirement plans through an IRA chassis which provides streamlined administration and little fiduciary responsibility, if any, an ERSA arrangement maintained by an employer with 10 or fewer employees will satisfy the ERSA rules if contributions are made to an IRA established on behalf of the employee.

WOULD ERSAs BE ACCEPTABLE TO EMPLOYERS?

If the ERSA were only applicable to 401(k) plans and optional for the other types of plans, it would be embraced by many, if not most companies. Because the new ERSA discrimination test would be so much easier than the existing ADP and ACP tests, it would seem that companies sponsoring 401(k) plans would view such a change as truly beneficial making the additional employee communication costs and software costs that would have to be expended to make such a change acceptable.

The problem with ERSAs comes into play with the 403(b) plans, SARSEPs and SIMPLE IRAs. If the ERSA is intended to only apply to an ERISA 403(b) plan then there should not be a problem. If it is intended to be applicable to all 403(b) plans, then sponsors of non-ERISA 403(b) plans would now be subject to a non-discrimination test where none applied before.

Today SIMPLE IRAs are not limited to companies with only ten employees so that this change could be viewed as taking something away from small businesses. (A SIMPLE IRA plan is available for employers who have no more than 100 employees who earned \$5,000 or more in compensation during the previous calendar year.) Under a SIMPLE IRA, the employee may elect

to receive cash or have the employer contribute up to \$10,500 of the employee's compensation to the employee's SIMPLE IRA account. In addition, the employer must either make matching contributions or nonelective contributions to the SIMPLE IRA on the employee's behalf. The employer is required to match 100% of the employee's deferral up to 3% of the employee's compensation. Alternatively, the employer may elect to make a nonelective contribution of 2% of compensation for each eligible employee who has at least \$5,000 of compensation from the employer for the year. Under the ERSA plan, these small employers would be allowed to make the larger contributions that could be made to the 401(k) plan but companies with more than ten employees would have to use the trustee and protected approach of the "real" qualified retirement plan. The SBCA thinks that the ERSA proposal strikes the right balance between allowing higher contributions but having the funds protected and insulated by an ERISA protected trust.

Thus, the new ERSA rules for SIMPLE IRAs would give small business owners something they have wanted for a long time – the higher contribution limits allowed under 401(k) plans, but this change comes at a cost. It will only be applicable to small businesses with ten or fewer employees. One would think that the small business community would have been upset with this change, but virtually every major association representing small businesses has embraced ERSAs.⁹ It appears that the Administration wisely decided that the higher limitations deserve the higher safeguards of a trustee plan rather than an IRA.

WOULD ERSAs ACCOMPLISH THE GOAL OF SIMPLIFICATION?

ERSAs would definitely simplify the qualified retirement plan area, which is without a doubt one of the most complex areas of the tax code. Today, there are different rules that apply to each of different types of plans which allow employee deferrals or after tax contributions. It is hard to justify from a policy viewpoint why rules that are different because of historical reasons which are no longer valid should hold up the simplification of the whole system dealing with employee contributions. When viewed from the macro level, the ERSA plan would effectively make all of these types of plans basically 401(k) plans with simplified and easier non-discrimination testing. This seems to be an eminently fair way to bring these diverse plans under one plan design while simplifying the overall structure of the 401(k) plan at the same time.

IS IT LIKELY THAT CONGRESS WILL ENACT ERSAs?

It is not clear whether Congress would pass ERSAs. There are certain members of Congress who believe that the current rules and the discrimination tests, in particular, are

⁹ It is possible that these small business associations may have embraced the reduced number of employees to be eligible for the ERSA IRA plan, because they assumed that the Administration's proposals on Retirement Savings Accounts (RSAs) and in particular, Lifetime Savings Accounts (LSAs), would also be adopted. Many members of Congress were concerned that small business owners would simply fill up these accounts for themselves and drop the employer plan. They were also concerned that savings would be first put into the LSA rather than into a 401(k) plan because there were no penalties for withdrawal at any time. The SBCA believes that the LSA in particular could be very detrimental to increased retirement plan formation. The SBCA is not suggesting that the ERSA move through with its companion proposals, the LSA and the RSA, rather we believe the ERSA should be adopted on its own.

worth their complexity and the additional administrative costs they generate because they can cause the employer to give extra plan contributions to certain non-highly compensated plan participants to pass the tests, or alternatively cause certain highly compensated employees to have to take back a portion of their 401(k) contributions because the tests have not been passed. Given the grave lack of retirement savings facing the nation at this time, it seems shortsighted to require anybody (even if highly compensated) to have funds removed from a retirement plan. Further, the SBCA believes that the costs generated by these non-discrimination tests would be better spent by the company putting the money towards plan contributions or necessary administrative expenses. It is likely however, that in order to convert all of these different plans over to ERSAs, most of which have different non-discrimination tests, that coming up with one set of tests, which in some cases is harsher than the existing tests and in other cases, more lenient, would be the only way to get this much desired simplification into law.

There is no question that this major simplification would significantly assist IRS agents in auditing plans and would make it easier for many companies to know what they need to contribute without the necessity of hiring skilled plan administrators to run the non-discrimination tests for them. If one were to factor in all of these costs, one would think that Congress should embrace the ERSA as a well thought out proposal that should be enacted for the sake of simplicity.

401(K) SAFE HARBORS

Safe harbor provisions were added by Congress to the 401(k) plan specifically to make the plan more attractive to small business.¹⁰ Prior to 1999, all 401(k) plans were subject to complicated discrimination plans which tied contributions that highly compensated employees could make to the contributions made by non-highly compensated employees. These tests are expensive to administer. Additionally, if non-highly compensated employees did not optimize their participation, then highly compensated employees could not contribute as much as they wished.

It is now possible for 401(k) plans to eliminate the discrimination tests and allow every employee (including highly compensated employees) to contribute up to the maximum. Under current law, a 401(k) plan will be treated as meeting the discrimination tests if the employer: (i) makes a contribution for every eligible non-highly compensation employee equal to at least three percent of that employee's compensation (referred to as the 3% non-elective contribution); or (ii) makes a required matching contribution set forth in the tax code. These contributions must be 100% vested and made to every employee even if he/she does not meet the 1,000 hour requirement or is not employed on the last day of the plan year. In addition the employer must provide written notice to employees apprising the employees of their rights and obligations under the plan. This notice must be comprehensive and be written in "plain" English.

There appears to be no rationale for having advanced notice in the context of the non-

¹⁰ I.R.C. § 401(k)(12) as amended by Small Business Job Protection Act of 1996.

elective three percent contribution - no employee is going to change any behavior with respect to making 401 (k) contributions merely because a contribution will be made for them at the end of the year.¹¹ If anything, it could depress employee contributions since the employee might be satisfied with the employer's contributions alone. The notice requirement, however, may have an inadvertent chilling effect on a company's ability to use the safe harbor. Unless an outside advisor informs a small business that it must give a fairly extensive written notice to employees about the safe harbor by a certain date and the company complies with the notice requirement, the company may not be able to take advantage of the safe harbor for an entire year. Treasury and IRS have worked around this requirement as much as possible.¹² However, the notice requirement is a statutory requirement. Thus, Treasury and IRS are not capable of removing it. The notice requirement serves no purpose with respect to the 3% non-elective safe harbor. It is at best a nuisance and at worst a trap for the unwary. ***The SBCA suggests that the notice requirement for the 3% non-elective safe harbor requirement be eliminated. It serves no purpose.*** Note that if the ERISA was passed there would be no need to have the existing 401(k) safe harbors and all of the complexity under them would vanish.

TOP-HEAVY ISSUES IN THE 401(K) CONTEXT

The top-heavy rules discourage small businesses from allowing employees to become immediately eligible to participate in a top-heavy 401(k) plan in which the company is making plan contributions. In the normal retirement plan world (that is outside the top-heavy rules¹³), merely allowing a new employee to become eligible to participate in the 401(k) portion of a plan immediately upon employment would not, by itself, trigger any additional company contributions. In a top-heavy plan, in contrast, a non-key employee who is merely eligible to participate in the 401(k) portion of the plan must receive the 3% top-heavy minimum contribution even if he or she is not eligible to receive any other employer contribution (i.e., a profit sharing contribution or a match contribution).¹⁴ For example, if a small business sponsored a top-heavy profit sharing/401(k) combination plan which had a one year wait for eligibility for the profit sharing portion and immediate eligibility for the 401(k) portion, most practitioners believe that every non-key employee would be entitled to receive the 3% top-heavy contribution regardless of whether the employee chose to make 401(k) contributions. Unfortunately, as is the case with many of the obscure top-heavy rules, there are many advisors who are not even aware of this issue. Because of this requirement, knowledgeable small business retirement plan advisors tell their clients to have a one year wait for both the 401(k)

¹¹ The rationale for advance notice in the context of the match safe harbor is self evident. An employee may very well change his or her behavior and contribute more knowing that a match is going to be made.

¹² I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #1.

¹³ The top-heavy rules, because of the make up of most small businesses, basically apply to almost all small business plans and thus, small business plans counter intuitively are actually subject to increased burdens and additional costs as compared to larger businesses. This is an area where there is no parity between larger and smaller retirement plans.

¹⁴ Treas. Reg. § 1.416-1, Q & A M-7 and M-10 (as amended in 1992); 29 U.S.C. § 1002(7) (1999) (ERISA § 3(7)).

portion and profit sharing and/or match portion of the plan. This hurts the first year employees by keeping them out of the 401(k) portion of the plan for the first year, thereby delaying their chance to save in a tax free environment. If they were employed by a larger entity, they likely would not encounter this problem because the top-heavy rules would not apply. ***This rule should be changed so that any employee entering the 401(k) portion of the plan before meeting the one year eligibility requirement for the profit sharing portion of the plan is not entitled to the top-heavy contribution (nor to any profit sharing or gateway contribution).***

Perhaps the most unfair rule in the context of top-heavy 401(k) plans was imposed on small business through IRS regulations on employee pay-all plans.¹⁵ This rule converts 401(k) contributions made by key employees into employer (profit sharing) contributions, thus triggering the top-heavy minimum contributions. In effect, the key employees are precluded from making 401(k) contributions to an employee pay-all plan even if these employees would have been allowed to do so under the ADP rules. Because this rule only applies to top-heavy plans, it primarily affects small business.¹⁶ This is simply unfair to small business. ***If a larger entity (that is, one which is essentially exempt from the top-heavy rules) sponsors an employee pay-all plan, all employees (highly compensated, keys or otherwise) can make 401(k) contributions allowed by the ADP tests without triggering any profit sharing contribution. The very same plan, in the small business context, triggers a 3% top-heavy contribution for the non-key employees, if the plan is top-heavy.***¹⁷ ***The SBCA strongly supports changing this unfair rule - - changing this rule will encourage new small business 401(k) plans which will increase coverage.***

Because of this rule, most small businesses simply do not offer employee pay-all 401(k) plans. This represents a real lost opportunity to encourage small businesses to offer qualified retirement plans. These plans would allow small business employees to defer up to \$15,500 (or even higher if they are 50 or older) if allowed under the anti-discrimination tests (ADP tests). Small business owners likely would sponsor employee pay-all 401(k) plans, notwithstanding the administrative burdens and expenses, if they knew they could participate in the plan like other employees.

CASH BALANCE PLANS

¹⁵ Treas. Reg. § 1.416-1, Q & A M-20 (as amended in 1992).

¹⁶ The SBCA has never been able to come up with an acceptable rationale for this rule.

¹⁷ The top-heavy rules rankle small business owners. The top-heavy rules are one of the primary reasons why small business owners maintain that the qualified retirement plan system discriminates against them and small businesses. As mentioned above, the vast majority of small business plans are top-heavy because of the mechanical mathematical tests utilized to determine top-heavy status which largely depend upon the number of key employees, as defined under I.R.C. § 416, employed by the company compared to the number of non-key employees.

In the small business world, cash balance plans are probably *the most desirable plan* a company can sponsor. Due to legislative changes in the 1980's, small business by and large has no interest in the defined benefit plan system. For this reason, small businesses are not confronting the same conversion issues as are large companies who are changing their defined benefit plans into cash balance plans. Some small businesses, however, do sponsor cash balance plans. **The cash balance plan is the plan of choice since it blends the best of the defined contribution and defined benefit worlds.**

The cash balance plan looks like a defined contribution plan built upon a defined benefit chassis. The plan is essentially a defined benefit plan, but unlike a defined benefit plan it provides separate account balances for each plan participant. By providing individual account balances, cash balance plans give employees a "proprietary" interest in the plan and they know how much they have in the plan. At the same time, the cash balance plan offers many of the safeguards of a defined benefit plan. Of greatest importance, the investment risk is assumed by the employer rather than the employee. Congress went a long way towards encouraging new formation of this type of plan by making it clear that these plans are not inherently age discriminatory. Congress should continue to encourage formation of this valuable plan for small business employees.

REQUIRED BEGINNING DATE

Employees, other than 5% owners, may delay distributions from qualified retirement plans until actual retirement if that date is later than the date that otherwise would be the employee's required beginning date. ***This rule should be extended to 5% owners. By and large a 5% owner is a small business owner.*** If the small business owner is still working, this rule in effect requires the small business owner to remove retirement funds sooner than he or she would need them. There is no apparent policy rationale for this result. First, this approach is financially wasteful since the account owner is forced to withdraw retirement assets prior to retirement. When the business owner actually does retire, he or she will have fewer assets in the plan. Since the withdrawn assets are reduced by income taxes, only the after-tax dollars are available for re-investment and the appreciation on these investments is subject to additional tax as interest, dividends or capital gains are realized. This deleterious impact is compounded by the fact that small businesses seldom provide any retirement income security other than through the retirement plan.

SIMPLIFICATION SHOULD BE OPTIONAL

Many changes which are intended to simplify the qualified retirement plan system should be optional. The 401(k) safe harbors are an excellent example of an optional simplification. Although these safe harbors create an alternative to the cumbersome ADP and ACP tests, companies are free not to utilize these alternatives. Indeed, larger companies often choose not to use the safe harbor because they consider a 3% employer contribution or required match contribution too high a price to pay for the reduced administrative burdens. Many companies expend significant time and money on their retirement plan software and/on employee communications. For these companies the cost of new software and written communication

materials for employees may exceed the prospective administrative savings offered by the safe harbor. Thus, what may look like simplification to Congress may end up costing companies countless dollars and time. By making these intended simplifications optional, companies retain the flexibility to decline the “savings” of the perceived “simplification.” Perhaps an exception to this general rule would be the ERSA where the costs of moving everyone over to the easier plan would be justified by the overall dramatic simplification in the system.

NEW USES FOR 401(K) PLANS

The 401(k) plan could be utilized to allow employees to make pretax contributions to a retiree health care account. This would enable employees to afford supplemental health insurance after retirement. The 401(k) feature could be expanded to include a second account into which the employee could make contributions for his or her retiree health care. This could operate essentially as a HSA. Funds accumulated in the retiree health care account would, as with the 401(k) account, grow tax deferred, and qualified contributions by the employees would be exempt from income tax. Upon the employee’s retirement, disability or termination of employment, the employee would be allowed to roll over the retiree health care account to an HSA. Money in the retiree’s health care accounts could be used to purchase supplemental health insurance, to defray major medical expenses that are not covered by insurance (possibly even if needed prior to retirement) or even to purchase long term care insurance or pay for long term care costs.

The permissible maximum annual contribution to a retiree health care account would, of course, need to be determined by Congress after taking into account projections of the costs that the nation would have to absorb in the next two or three decades if retirees cannot provide for those long term care or medical expenses not covered by the Government. The lost tax revenues resulting from incremental contributions to long term health care and retiree health care accounts (in addition to the § 415 limits which apply to profit sharing and 401(k) contributions) may be smaller than the increased governmental expenditures needed in the next few decades to provide long term care and retiree medical care to retirees who lack adequate savings to provide for this care themselves.

FORM 5500

The Form 5500 is administratively burdensome and might well prove a deterrent to small businesses considering switching from a SIMPLE to a 401(k) safe harbor. With the SIMPLE the annual reporting requirements are imposed primarily on the IRA trustee or custodian, with a 401(k) plan, significant reporting requirements are imposed on the employer. These reporting requirements are so daunting that many small businesses simply may not be able to handle these forms internally. They will need to engage outside benefits advisors, at considerable cost, to ensure compliance. This form should be simplified significantly for small businesses, particularly for plans with fewer than twenty-five employees. The objective would be to devise a form that provides the IRS and Department of Labor with sufficient information to monitor compliance matters but that can be readily completed by the owners or the company’s accountant without relying upon a retirement plan expert. This would reduce administrative costs which are higher for small business plans than those paid on a per participant basis by larger companies.

HELP NEEDED FROM IRS

For whatever reasons, in the last few years the laws and regulations governing the retirement plan system have become increasingly complex. Practitioners around the country are getting confused by the new laws, such as many of the new rules contained in the Pension Protection Act and even more confused by all the regulations and guidance coming out with respect to the new laws. It would be extremely helpful if the Internal Revenue Service provided practitioners with more examples, sample language and safe harbors. It would be extraordinarily helpful to the smooth operation of the qualified retirement plan system, if Congress urged IRS to actively assist practitioners in this regard. Finally, every time Congress changes a retirement plan law, it should provide for significant transition relief. Currently, plans are being required to be amended on an annual basis and it is beginning to really drag down the welfare of the system with unnecessary complexity and cost.

TAX REVENUE LOSS FROM IMPROVING RETIREMENT PLAN COVERAGE

SBCA suggests that a sea change is needed in how we view our loss of tax revenue due to increased retirement contributions by employees and employers. This revenue is not “lost,” it is merely deferred. Further, the short term loss of those tax dollars may do more for the income security for our taxpayers in their retirement than almost any other change in the tax code. For example, reducing the marriage penalty may provide extra dollars to raise living standards for families in the short term. But these families are not likely to use a significant portion of those dollars to save for retirement, medical disasters or long term care. Instead they will rely on Social Security and a company sponsored retirement plan. The relatively few dollars that would be required to make these suggested changes would return far higher dividends to the country's well being than almost any other tax expenditure.

Because qualified retirement plans are subject to a myriad of technical, micro-focused rules, relatively small changes (“micro” changes) in the qualified retirement plan system can bring about a substantial or “macro” result. A change in a single technical rule can have a dramatic impact.

The qualified private retirement plan system is remarkably successful. By making the changes set forth above, (which are by no means intended to be exhaustive), small businesses will continue to embrace qualified private retirement plans so that small business employees will receive the significant benefits of retirement plan coverage.

THE LATEST SIMPLIFICATION TRAGEDY: NEW MONSTER IRS CODE SECTION 409A – NON-QUALIFIED DEFERRED COMPENSATION PLANS

Perhaps the most egregious area where immediate relief is needed for small business is under new IRC section 409A. Congress enacted 409A in response to the abuses seen in the

Enron, WorldCom, and similar situations. Its goal in creating this statute was to protect investors (and arguably the employees) in publicly traded companies. For publicly traded companies, the goals of 409A were, and still are, valid and important. However, its application to small businesses is unnecessary and unduly burdensome- the very opposite of what Congress intended. Accordingly, SBCA respectfully requests that Congress revise Section 409A so as to exempt (i) nonpublic companies or (ii) all companies with fewer than 100 stockholders or (iii) all companies using the cash basis method of accounting and all entities utilizing a pass through entity or (iv) all companies with gross receipts of less than \$10,000,000.

409A requires all amounts deferred under a nonqualified deferred compensation plan (including arrangements set up by the employer unilaterally with no employee involvement or choice) after December 31, 2004 to comply with new, very, very complex rules. If these rules are violated, the amounts are currently included in the employee's income and also are subject to an additional 20% income tax.

In cases such as those of Enron and Worldcom, corporate executives either had or created large nonqualified deferred compensation accounts and withdrew their balances shortly before the corporation declared bankruptcy, effectively depleting company funds to the detriment of investors. These types of abuses simply do not exist in the small business arena. Due to the close identity of the owners and the executives in private businesses, there is no abuse by executives at the expense of shareholders. In public companies, those controlling the business (executives and directors) are often owners of a small percentage of the outstanding stock. In private businesses, the close alignment of the interests and identities of the owners and executives creates inherent safeguards – safeguards that were not present to protect the shareholders in Enron and similar cases.

The scope of 409A spans much farther than many originally expected or is warranted. It not only encompasses traditional nonqualified deferred compensation arrangements, but as interpreted by the IRS and Treasury, it also extends to *any* agreement which could conceivably have the possible effect of allowing an employee to receive income in the future. This is certainly not the traditional definition of a non-qualified deferred compensation with which tax practitioners or small business advisors are familiar. The effect of this is that owners of closely-held business must scramble to review, among other things, their employment agreements, buy-sell or other purchase agreements, stock options, restricted stock arrangements, partnership agreements, limited liability company operating agreements, and numerous other standard business arrangements. Because the reach of 409A is so great and the rules so complicated small businesses have spent and will continue to spend a great deal of money in unnecessary legal and accounting expenses. 409A prevents common sense economic arrangements that are sensible for the employees and businesses and pose **no** opportunity for abuse.

Congress wrote a five page Internal Revenue Code section to protect investors from top executives raiding a company by leaving with huge sums of money in non-qualified deferred compensation plans immediately prior to the company's collapse. It is not likely that Congress bargained for the 400 pages of regulations (with more guidance coming out soon!) that will

require teachers to make an election before the year begins if they want to take out their salary over a 9 month period instead of a 12 month period. It is doubtful that Congress is or has been concerned about teachers deciding during the school year whether they want to take their salaries over a 9 month period or a 12 month period – but under 409A this is now a timing issue which is somehow deemed to be abusive and needs to be curbed. Initially small business advisors did not think 409A would apply to many small businesses because few small businesses have non qualified deferred compensation plans – because of tax reasons small businesses cannot afford to set up a plan where there is no deduction. Unfortunately the regulations make it clear that 409A applies to many situations that are not non qualified deferred compensation plans. Just last week, many tax practitioners listened to two governmental spokespeople on an ABA program explain that language found in almost every agreement providing that payments to be made to an employee after termination of employment “as soon as practicable” will have to be changed because that is not acceptable under the regulations. It is ridiculous for privately owned companies to spend countless dollars to comply with these overreaching regulations when there is virtually no policy goal being achieved.

Since Congress drafted 409A in such a way that its application could be construed very broadly and the Department of Treasury, in turn, interpreted the statute to be applied as such, 409A has developed into the very antithesis of simplification. In fact, the Treasury Regulations issued for 409A are nearly 400 pages long! Until two days ago, small businesses were suppose to have all of their agreements in operational compliance with 409A by the end of this year. Those small businesses fortunate enough to have advisors who are even aware of this new burdensome and overly broad section are at least attempting to deal with the unnecessary and costly changes that will be made to their operating agreements. The vast majority of small businesses, however, are simply not even aware that 409A exists nor are they aware of the extraordinary tax penalties that will apply to them. Private businesses and their advisors are experiencing significant uncertainty and burdens as a result of the new provisions, and the burdens far outweigh any possible public benefit. This is completely counterintuitive to Congress’s greater goal of providing certainty, simplicity, and fairness in the tax code.

Furthermore, no real income deferral results from nonqualified deferred compensation arrangements in the typical small business context. A private business (or its owners, in the case of a flow-through entity) pays taxes on income as earned. It receives no deduction for deferred compensation paid unless and until the amounts are includible in income by the employee. Accordingly, the perceived need for specific tests when nonqualified deferred compensation arrangements in fact defer income is misleading. The real issue is when the incidence of taxation shifts from the employer to the employee. Therefore, there would be little or no revenue impact from restricting the application of 409A to publicly traded companies.

409A is also problematic in that it inhibits negotiation of severance pay agreements where it is in the business interest of the employer to accelerate payments in exchange for a reduction in the amount due. There may also be valid business reasons for an employer to pay off a deferred compensation obligation earlier. This is usually done by paying bonuses during employment. This would currently violate both the rule against acceleration and the rule that

precludes payments except on termination of employment or change of control.

Another issue surfaces where small employers, who often prefer to issue stock options at low values as an added incentive to employees, also risk running afoul of 409A. 409A applies if the exercise price of the stock option is below fair market value as of the date of the grant. But the value of a closely-held company is often open to debate, even among valuation experts. As such, the uncertain value of closely-held business interests presents a huge risk to a closely-held businesses considering issuing stock options since, under 409A, the IRS can challenge the value (even if supported by an independent appraisal).

Existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business, where Enron-type abuses do not occur. Moreover, any perceived abuses could be eliminated by simply tightening up the rules already applicable to these arrangements instead of creating a new section to the tax code, especially one like 409A that comes along with its own 400-page set of incomprehensible regulations. Congress should create an exemption similar to that applied to IRC Section 280G exempting private businesses with fewer than 100 owners. Alternatively, Congress could exempt all nonpublic companies from 409A or all companies using the cash basis method of accounting and all entities utilizing a pass through entity or all companies with gross receipts of less than \$10,000,000. In the alternative, Congress could exempt specific arrangements from 409A, such as buy-sell agreements, salary continuation arrangements for owners who are slowing down (phased in retirement), and equity positions subject to a vesting schedule of a privately owned company. Small businesses and our country's economy would be better served if they could take the money they will have to spend on tax advisors to cope with 409A, and instead invest more money in making their businesses profitable and contributing significantly to our nation's economy.

The Effects of 409A: An Example

Suppose Rural Medical Practice has several family practice doctors, and one, Dr. Senior, wants to be able to slow down but not fully retire. Rural Medical Practice values Dr. Senior, who is a valuable resource for the community, and would like for him to continue working. On the other hand, to economically survive, the practice needs to limit his pay based on productivity. By contrast, Dr. Senior would like to supplement his reduced income during his slow down period (e.g. phased in retirement). Rural Medical Practice is obligated by agreement to pay its retired doctors an amount of money based on the doctor's 3 average years of income over the last 5 years and it pays this obligation to the doctor in equal amounts over a 5 year period.

Before 409A:

As an incentive to encourage Dr. Senior to continue working as a doctor, Rural Medical Practice would propose to allow Dr. Senior to begin receiving a portion of the payments that Rural Medical Practice usually pays to its doctors once they retire, while still employed with the practice. Assume that Dr. Senior has decided that he will work one-third of his regular workload

and Rural Medical Practice would begin to pay him his “retirement” payments immediately (the medical practice would waive the requirement that Dr. Senior must retire to begin receiving payments) and in exchange for beginning to make payments prior to actual retirement, Dr. Senior would agree to have the payments made over a seven year period rather than five. Rural Medical Practice would fund these payments at least partly with the collection of Dr. Senior’s accounts receivable, particularly those received by the practice after his actual retirement. This arrangement would permit Dr. Senior to work a reduced work schedule (which not only benefits him but perhaps more importantly his patients who rely upon his valuable medical service to the community) and be able to afford the slow down. This type of arrangement is very common with small business owners today and will become more common as the baby boomers approach traditional retirement age while the average life expectancy has moved well into the 80’s. Many experts on the Hill have been working on how to encourage exactly this type of phased in retirement.

After 409A:

If Rural Medical Practice has sophisticated tax advisors, they hopefully would warn Rural Medical Practice that the proposed arrangement could violate 409A, and the payments made to Dr. Senior could be subject to both the imposition of current tax and the significant penalties imposed by this code section. This is because Dr. Senior would be working at a 33 1/3% level which, under the regulations, would give rise to a facts and circumstances determination (presumably by the IRS) as to whether Dr. Senior has separated from service thereby allowing the payment of the severance payments in compliance with 409A. Once Dr. Senior’s performance (that is, the level of services performed by him) decreased to a level equal to 20% or less of his average level of performance during the 36-month period immediately preceding the commencement of the deferred compensation arrangement, Dr. Senior would be presumed to have separated from his service with Rural Medical Practice and at that decreased level of performance there would be no penalty.

Thus, Rural Medical Practice and Dr. Senior would be forced to try to fit Dr. Senior’s phased in retirement goals into a tax code provision which should have NO application to the situation described. Neither Rural Medical Practice nor Dr. Senior has deferred any income from Dr. Senior in a prior year to a later year, and even more peculiar, by changing the existing arrangement, Dr. Senior would be actually accelerating income into an earlier taxable year – nevertheless under 409A this would be prohibited and significant penalties would attach. Worse, it is very likely that Rural Medical Practice would have no idea that 409A applied to this type of situation so that Rural Medical Practice would have walked into a trap for the unwary while doing exactly what was best for the surrounding community desperately in need of qualified doctors.