



IMPACT OF TAX REFORM ON THE SMALL BUSINESS

TAX GAP: REFORM AND SIMPLIFY EMPLOYEE BENEFITS TAX LAW

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TAX GAP: REFORM AND SIMPLIFY EMPLOYEE BENEFITS TAX LAW

§ 1.01 CLOSING THE TAX GAP

Everybody in Washington is talking about the “tax gap.” This is the new buzz word for the difference between the amount of tax revenue the federal government would receive if all Americans paid their taxes compared to what it actually receives. Rather than increasing taxes, Congress would much prefer to close the tax gap. In 2006, IRS estimated the tax gap to be \$290 billion for tax year 2001. Thus, it is clear that if everybody paid their fair share of taxes, the government’s deficit would be significantly reduced. No wonder Congress and the Administration are exploring ways to close the tax gap.

Last year, the U.S. Department of Treasury issued a comprehensive strategy for reducing the tax gap.¹ The report sets forth a seven pronged approach for closing the tax gap: reduce the opportunities for evasion; commit to additional and sustained research; improve information technology; improve compliance methods; provide more taxpayer service; improve the coordination between IRS and state and foreign governments and *reform and simplify the tax law*. The Treasury believes that errors are caused by complexity since taxpayers do not understand the law. Further, the report contends that it would be harder for taxpayers to evade taxes if the laws were simplified while at the same time, it would be easier for IRS to enforce the tax laws. As an example of such simplification, the report highlights the Administration’s proposal contained in its

¹ U.S. Department of the Treasury, Office of Tax Policy, “A Comprehensive Strategy for Reducing the Tax Gap” (September 26, 2006).

revenue budgets for the last several fiscal years to consolidate all defined contribution types of plans that permit employee pre- or post- tax contributions into one new type of plan called the “Employer Retirement Savings Accounts (ERSAs)”.

§ 1.02 EMPLOYER RETIREMENT SAVINGS ACCOUNTS

President Bush proposed the adoption of Employer Retirement Savings Accounts as part of the Administration’s Fiscal Year 2004 Revenue Proposals² in an effort to reduce some of the perceived unnecessary complexity in the employer retirement plan arena. The Administration has continued to propose ERSAs in each of its fiscal year revenue proposals thereafter. On March 8, 2005, Representative Sam Johnson for himself and for Representative English introduced H.R. 1161 to add Section 401A to the Internal Revenue Code to provide for ERSAs. On the same day Senator Thomas for himself and for Senator Kyl proposed S. 547, a companion bill to H.R. 1161.

The impetus behind ERSAs is the reasoned decision to provide employers with a form of 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,

² 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.

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.”³

An ERSA is a proposed retirement plan designed to replace several current forms 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 within the meaning of Code Section 408(k), Thrift plans, SIMPLE IRAs under Code Section 408(p) and SIMPLE 401(k) plans. ERSAs would be subject to the current rules governing 401(k) plans, including the rules governing contributions and distributions. For example, similar to current Code Section 401(k)(2), an ERSA is an arrangement under which an employee may elect to have the employer make payments as contributions to a trust under a plan on behalf of the employee, or to the employee directly in cash where the funds held in the ERSA attributable to employer contributions made pursuant to the employee’s election (A) may not be distributable to participants or other beneficiaries earlier than (i) severance from employment, death, or disability, (ii) the termination of the plan without the establishment or maintenance of another defined contribution plan; (iii) the attainment of age 59½; or (iv) upon hardship of the employee,

³ General Explanations of the Administration’s Fiscal Year 2008 Revenue Proposals, Department of the Treasury, February, 2007 at 13.

and (B) will not be distributable merely by reason of the completion of a stated period of participation or the lapse of a fixed number of years; (C) which provides that an employee's right to the employee's accrued benefit derived from employer contributions made to the trust pursuant to the employee's election is nonforfeitable, and (D) which does not require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan extending beyond the period permitted under Code Section 410(a)(1). The tax rules governing the contributions and distributions from an ERSA would be identical to the tax treatment of such 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.⁴ An ERSA must provide that the contribution percentage for eligible HCEs for the plan year does not exceed 200% of such percentage for the nonhighly compensated employees ("NHCEs") if the contribution percentage of the NHCEs did not exceed 6%, or if the contribution percentage of the NHCEs exceeded 6 percent, there would be no nondiscrimination test.

In addition, both the Administration's proposals and the legislative proposals 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

⁴ The ACP test and the ADP test would no longer be applicable.

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.⁴

Further, in an effort to continue 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 eligible employer shall not fail to meet the requirements governing ERSAs merely because contributions under the arrangement on behalf of any employee are made to an individual retirement account described in Code Section 408(a) or and individual retirement annuity described in Code Section 408(b) established on behalf of the employee. For these purposes an "eligible employer" means, with respect to any year, an employer which had no more than 10 employees who received at least \$5,000 of compensation from the employer for the preceding year.

As proposed, the effective date for the ERSA would be for years beginning after December 31, 2007. The proposal contemplates that all existing 401(k) plans and thrift plans would be *renamed* ERSAs and would continue basically unchanged except for the simplifications set forth in the proposal. SIMPLE 401(k) plans, SIMPLE IRAs,

⁴ The proposal provides that "any alternative formula such that the rate of an employer's matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made on the basis of the percentages described in the first formula...the rate of matching contribution with respect to an HCE at any rate of elective contribution cannot be greater than that with respect to an NHCE." General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals, Department of the Treasury, February, 2007 at 15.

SARSEPs, 403(b) plans and governmental 457(b) plans would have two choices – they could choose to become ERSAs and be subject to all of the ERSA rules or they could in effect continue as is but the plan would not be allowed to accept any further contributions after December 31, 2008.⁵

[1] Will ERSAs Be Acceptable To Those Employers Sponsoring Plans That Are Required To Become ERSAs

If the ERSA were only applicable to 401(k) and optional for the remaining 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. It may be that the ERSA is intended to only apply to an ERISA 403(b) plan, but if so, the proposal is certainly not clear on this point and would seem to indicate that it will be applicable to all 403(b) plans.⁶ Thus, for sponsors of non-ERISA 403(b) plans, additional complexity would result inasmuch as there would now be a non-discrimination test applicable to these plans where none applied before.

Additionally, SARSEPs⁷ and SIMPLE IRAs are not limited to companies with only ten employees so that this change could have a significant detrimental impact on the

⁵ The proposal states that there will be special transition rules for collectively bargained plans and plans sponsored by State and local governments. *Id.*, at 14.

⁶ The description of the various plans that would be changed to ERSAs states under 403(b) plans that “Some 403(b) plans are subject to some nondiscrimination rules.” *Id.*, at 13.

⁷ SARSEPs are effectively surviving only as grandfathered plans – plans that were in effect on December 31, 1996 are allowed to continue. No new SARSEPs were allowed to be established after said date. SARSEPs are available only for employers who have no more than 25 eligible employees at all times during the previous taxable year.

formation of new SIMPLE IRA plans. 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.

Small businesses have requested for a number of years to have the higher contribution levels allowed under the 401(k) plan to be made through the IRA chassis. 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 SIMPLE (an IRA based plan) and the advantages afforded by a qualified retirement plan (a trust based 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 correct contribution into each separate

IRA and then walks away from the accounts. Unfortunately, this low administrative burden comes at a price.

In a qualified retirement plan, such as a 401(k) plan, the employer holds funds in a trust. Because the funds are held in a trust, employees cannot simply access their account balances whenever they determine they are in need of funds. Indeed, employees can access these funds in only two ways. First, in some circumstances, they can take a loan. If the plan allows loans and the employee complies with all of the statutory requirements, then he or she may remove certain limited savings through a written plan loan. Second, the employee may receive distributions if an event occurs which, under the law, permits distribution. These events include hardship (if the plan allows hardship distributions), death, disability, retirement or termination of employment. Statutorily defined hardship distributions include, for example, distributions needed to assist with keeping a house or dealing with a medical emergency. Essentially, in a qualified retirement plan (a trust based plan), once funds are contributed to the plan, the employee, in most situations, is forced to maintain the funds in the plan until retirement, or other event permitting distribution.

In contrast, with the SIMPLE or SARSEP plans, funds are owned by the employee, not by a trust. Accordingly, employees can remove their funds from the brokerage house or bank *at any time, in any amount and for any reason*. True, removed funds will be subject to an early withdrawal penalty. (This is also the case for a hardship distribution from a 401(k) plan.) Nonetheless, the employee retains total access to these funds.

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 quite 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 most of the major associations representing small businesses embraced ERSAs.⁸ It appears that the Administration wisely decided that the higher limitations deserve the higher safeguards of a trusted plan rather than an IRA.

Because the SARSEP remains only in grandfathered format and that in effect, Congress has already determined that it is not a plan worth continuing, it would seem that the concerns of the employers still sponsoring SARSEPS should be disregarded in the interests of simplification.

[2] Will ERSAs Accomplish The Goal of Simplification?

ERSAs would definitely simplify the 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 these 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 particularly valid should hold up the simplification of the whole system dealing with employee contributions.⁹ When viewed from the macro level, the ERSA plan would effectively make all of these types of plans

⁸ It is possible that these small business trade 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. Thus, it is safe to say that the RSA and LSA proposals will not be adopted in the near future, if ever.

⁹ Perhaps some justification exists for keeping the non-ERISA 403(b) plan outside of the ERSA scheme.

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.

[3] Will Congress Enact ERSAs?

Congress would in all likelihood pass ERSAs (and not RSAs or LSAs) if it did not have the streamlined non discrimination tests. There are certain members of Congress who believe that the current complexity of these tests are worth the extra money that may be given to certain plan participants to pass the tests, or alternatively the extra money that certain highly compensated employees must take out of the plan because the tests have not been passed. Given the grave lack of retirement savings facing the nation at this time, it seems short-sighted to require anybody (even if highly compensated) to have funds removed from a retirement plan. Further, 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.

§ 1.03 THE LATEST SIMPLIFICATION TRAGEDY: NEW MONSTER CODE SECTION 409A

In 2004, Congress acted in response to perceived abuses committed by corporate executives at companies like Enron and WorldCom by enacting new Section 409A of the Internal Revenue Code of 1986, as amended.¹⁰ For publicly traded companies, the goals of Section 409A were, and still are, valid and important. However, its application to small businesses is unnecessary and unduly burdensome – the very opposite of what the Administration and Congress should be undertaking to close the tax gap by simplifying the tax laws. The burden of failing Section 409A is borne by employees and since small businesses are often uninformed, Section 409A has (or better, will) become a trap for the unwary. Because Congress drafted this new code section in such a way that its application could be construed very broadly and because IRS did interpret it to be applied in such a fashion, Section 409A has developed into the very antithesis of simplification. In fact, in the last month IRS issued regulations on this new code section that are nearly four hundred pages long!

The tragedy behind Section 409A is that it serves no meaningful purpose for *nonpublic* companies that can possibly justify the costs these businesses will have to expend on unnecessary legal and accounting expenses in order to comply with this almost nonsensical new code provision. Section 409A prevents common sense economic arrangements that are sensible for the employees and businesses and pose no opportunity

¹⁰ See the General Explanation of Tax Legislation Enacted in the 108th Congress, prepared by the Staff of the Joint Committee on Taxation (JCS-5-05), May 2005 which notes in footnote 941 that the staff of the Joint Committee on Taxation made recommendations similar to Code Section 409A in the report on their investigation on Enron Corporation.

for abuse. Unlike public companies and the well known problems of excessive executive and sometimes director deferred compensation at the expense of the shareholders, there *is* no abuse in private businesses by executives at the expense of shareholders due to the close identity of the owners, the executives and the stockholders in private businesses. The structure of privately owned businesses where those controlling the business (executives and directors) are almost always the controlling stockholders is totally different than that of public companies where those controlling the business (executives and directors) are often owners of a small percentage of the outstanding stock. Even where the shareholders are not in fact themselves the executives, in the private business context, they generally exercise direct supervision over their activities and compensation arrangements. Accordingly, there are inherent safeguards present in the private business model that are not present to protect the shareholders in publicly traded companies.

[1] Background to Section 409A

In general, whether compensation is taxed currently or on a deferred basis is determined under several long-standing statutory provisions and judicial doctrines. These include Code Section 83 (relating to property received for the performance of services), the doctrine of constructive receipt, the economic benefit doctrine, and others. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, and the payments are subject to a risk of forfeiture (meaning that creditors of the employer have priority over the potential recipient of the nonqualified deferred compensation), the compensation is includable in income when it is actually or constructively received. Correspondingly, the employer gets a deduction only when nonqualified deferred

compensation is actually paid, not earlier when the commitment to pay it is made. If the arrangement is funded, then income is taxed to the recipient for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture, whether or not it is paid later.¹¹

Overlaying those rules, Section 409A requires that 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 comply with very complex new rules.¹² 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 addition, the employee is required to pay interest at the IRS underpayment rate plus 1% on the underpayment that would have occurred if the amounts had been included in income when first deferred or, if later, when they were not subject to a substantial risk of forfeiture.¹³

Section 409A defines a "nonqualified deferred compensation plan" as any plan that provides for the deferral of compensation (other than certain enumerated exceptions). It includes plans where the employee has no election to defer. A plan generally provides for the deferral of compensation if it gives a service provider a legally binding right during a taxable year to compensation that (i) has not been "actually or constructively received and included in gross income" and (ii) pursuant to the terms of the plan (a) is payable to (or on behalf of) the service provider in a later year and (b) is not required to

¹¹ See House Committee Report, H.R. Rep. No. 108-548, pt. 1.

¹² Final Section 409A Regulations have been recently issued and are generally effective January 1, 2008. For periods prior to January 1, 2008, the standards and transition rules set forth in Notice 2006-79 continue to apply.

¹³ Explanation from comments of American Bar Association: "The Application of Section 409A to Transactions Involving Partnerships," submitted to Mark W. Everson, Commissioner of the Internal Revenue Service on May 20, 2005.

be “actually or constructively received” by the employee within 2½ months after the end of the tax year of the employee in which it is no longer subject to a substantial risk of forfeiture (or if later, 2½ months after the end of the tax year of the service-recipient in which it is no longer subject to a substantial risk of forfeiture.)¹⁴

Section 409A imposes three restrictions on (i) distributions; (ii) acceleration of payments; and (iii) the employee’s election of payment. The provisions must be satisfied both in form and operation. The scope of Section 409A spans much farther than many warranted and much farther than was probably ever imagined by Congress. It not only encompasses traditional nonqualified deferred compensation arrangements (such as so-called rabbi trusts and secular trusts), but as interpreted by the IRS and Treasury, extends to any agreement which has the effect of deferring compensation. Thus, owners of closely-held business will be amazed to hear from their advisors that they will need to pay for a review, among other things, of their employment agreements, buy-sell or other purchase agreements (to the extent purchase obligations are measured by productivity or contain severance pay), stock options, restricted stock arrangements, partnership agreements, limited liability company operating agreements, and numerous other standard business arrangements, to determine whether they contain any potential exposure to premature taxation (before receipt of the funds) and the severe penalties imposed by Section 409A for nonconforming deferrals of compensation.¹⁵

¹⁴ Treas. Regs. §1.409A-1(b)(4)(i)(A).

¹⁵ The reason why small business owners and owners of closely held businesses are not yet aware of 409A is that they have yet to be informed by their advisors of the serious problems facing them in this area. This is due primarily to two factors – the first is that when 409A first came out, spokespeople from Treasury said that it would *not* apply to these types of arrangements (which of course was way too logical to remain the answer) and second, that the section is so complicated and the regulations so long that the advisors to these businesses have been holding off on becoming expert in an area that is so complex. Many small business advisors believe that Congress will exempt most small businesses from the reach of Section 409A

The complexity and wide reach of Section 409A has spawned an industry, both on the government side and in private practice, as clients and their advisors (and the IRS, for that matter) struggle to understand and define the scope and relevant operating rules. Although the IRS and Treasury have issued several rounds of guidance, including final regulations, there is still the need for further guidance in this far-reaching and difficult area¹⁶. However, Treasury has not provided any exceptions for private businesses (where no abuses like those in public companies can occur). Despite this guidance, many tax experts continue to struggle in providing clear answers on the scope and applicability of §409A to many real-world situations.

[2] Justification for Section 409A

The justification for the enactment of §409A was to protect investors (including employees' ownership of stock in the employer's retirement plans) in publicly traded companies as a response to the abuses seen in the Enron, WorldCom and similar scenarios. In those and similar cases, corporate executives had, or created, large (and yes, very real) nonqualified deferred compensation accounts, and withdrew their balances shortly before the corporation declared bankruptcy, depleting company funds to the detriment of shareholders and creditors. As large public companies, the corporations' shareholdings were very broad, and the shareholders had no direct input or control over corporate activities, learning too late of the draining of the nonqualified deferred compensation accounts and the collapse of the corporation's financial position.

(since the section serves no purpose with respect to these companies) and that for most *nonpublicly traded companies*, Section 409A will go the way of Section 89.

¹⁶ The Final Regulations do not address the calculation of income exclusion and funding, both of which have been reserved. In addition, contemporaneously with the issuance of the Final Regulations, IRS issued Notice 2007-34, to provide guidance regarding the application of Section 409A to split-dollar life insurance arrangements.

It appears IRS believes that Section 409A was enacted additionally to provide uniform and specific rules on when income deferral should be allowed in nonqualified compensation arrangements, even though in the small business context the rules were already well defined for tax purposes. Funded arrangements, as discussed above, were taxed to employees when they vested, even if they had not received any payments. Unfunded arrangements were taxed when payments were received, and only then could the employer take a deduction. Based upon discussions with the architects of the 409A regulations, it appears a primary issue for the IRS was the ability of a participant covered by a “real” non-qualified deferred compensation plan¹⁷ to determine the timing as to when he/she would take the funds in the plan into income. These “real” non qualified deferred compensation plans appeared to IRS to provide key employees too much freedom to decide as to when to bring the funds into income based on triggering events that were too easily manipulated. Interestingly, this is not at all the problem Congress was trying to fix in order to eliminate the sucking away of capital via a non qualified deferred compensation plan by the top executives to the detriment of the stockholders

¹⁷ The term a “real” non-qualified deferred compensation plan is by no means a term of art but is used here to distinguish between what every tax lawyer would clearly say is a non-qualified deferred compensation plan – one where a top hat employee is able either to defer receipt of his/her compensation by choice or has been awarded additional funds through a non-qualified deferred compensation plan, often used as golden hand-cuffs, with the new definition of non-qualified deferred compensation under 409A which encompasses almost any payments received by a participant that is not specifically excepted out by 409A. Thus, under 409A, if an owner of a small business receives payments after retiring, those payments may very well be deemed to be non-qualified deferred compensation. It is irrelevant that the owner was in fact *not deferring any income during the years that the owner was working nor was the company deferring income on behalf of the owner (in fact there is seldom enough income to distribute!)* and that the owner is merely receiving payments for the value of the company that he/she built up over decades of hard work – often being given his/her own receivables that have come into the company after the small business owner has retired. Under 409A this very common arrangement for small business owners that has *nothing* to do with non-qualified deferred compensation is now brought under Section 409A and can possibly subject the owner to all sorts of penalties. To say that small business advisors are struggling with this huge, complex code section is an understatement. Recently, one of the authors was following an e-mail stream on a list serv of exceptionally skilled tax attorneys and accountants who are amongst the most knowledgeable small business advisors in the country. This group could not even figure out whether 409A applied to an example not dissimilar to the one set forth above.

encountered in the Enron-type situation. IRS could have fixed the “abuses” it perceived with respect to the timing problem by issuing new regulations tightening up those rules. Section 409A is necessary in the context of companies where there is little to no identity between the executives, the directors and the stockholders. In situations, where actions taken by the executives and directors cannot be knowingly detrimental to the stockholders because they are largely identical, Section 409A is nonsensical and represents a colossal waste of time, money and talent.

[3] Small Business Issues with 409A

Small (not publicly traded) 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. In fact, one of the major problems with the application of Section 409A to privately owned businesses is that there does not appear to be *any evidence of any abuse* that could possibly merit the huge costs and complexity burden that is being imposed on these businesses by this new code section.¹⁸ Unlike in tax-qualified retirement plans, no real income deferral results from nonqualified deferred compensation arrangements in the realm of small business. The employer (or its owners, in the case of a flow-through entity) pays taxes on the income as earned. It receives no deduction for deferred compensation paid unless and until the amounts are includible in income by the employee (or independent contractor). Accordingly, the perceived need

¹⁸ It would be interesting to know whether the Office of Advocacy at the US SBA has undertaken an analysis of the impact of the 409A regs on small business and, if so, what it determined. In the authors’ view a cost/benefit analysis of these regs with respect to privately owned businesses would show that the cost is totally out of line with the perceived abuse they are intended to cure. Further, before subjecting privately owned businesses to such a complex, new structure, it would be helpful if Congress in the future would require IRS to analyze the projected dollars that would need to be expended by small business to comply with such a regulation and why such dollars are justified in light of some measurable, recurring and observed abuse by IRS. See Regulatory Planning and Review, Executive Order 12866 of September 30, 1993, as amended by E.O. 13258 of February 26, 2002 and E.O. 13422 of January 18, 2007.

for specific tests when nonqualified deferred compensation arrangements in fact defer income is misleading – the issue is essentially when the incidence of taxation shifts from the employer to the employee. It is expected that there would be little or no revenue impact from restricting the application of §409A to publicly traded companies. In the small business context, the level of complexity and risks imposed by Code Section 409A are harmful, burdensome, and completely inappropriate.

For example, assume Small Corp. has two shareholders and 30 employees. The shareholders are 59 and 62, and have invested in their company over the years. The company is now valued at about \$2.5 to \$3 million. However, the company is very entrepreneurial, dependent on the vision and leadership of its two shareholder-employees, and no outside buyers appear interested in buying it if the shareholders do not continue to be directly involved in guiding the company's future. The shareholders want to convert their business capital into retirement cash for the owners. A proposal is made to offer two current key management employees an option to buy the company at a relatively low price, provided it meets certain income goals at the end of five years, and subject to ongoing payment of extra income to the two shareholder-employees, which will be taxed to them as ordinary income, taxed at a much higher rate (35%) than would the same payments if treated as a part of the sale of their stock (15%) while they phase out of the business. The company's tax advisor tells the shareholders¹⁹ that the proposed arrangement is a nonqualified deferred compensation arrangement under Section 409A. Not surprisingly, the shareholders cannot understand why there is anything wrong with

¹⁹ Actually this example assumes a sophisticated advisor – there are still many small business advisors who think that Section 409A deals only with non qualified deferred compensation plans and if they are dealing with a client who does not have such a plan, they reasonably assume that this new monster code section which was intended to fix Enron-type abuses would not have any applicability to their small business client.

this arrangement, nor can they come up with any decent policy rationale for the imposition of Section 409A in this situation.

Section 409A also 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 can sometimes be a substantial savings in interest costs and a reduction in amount payable, particularly where the employee perceives a credit risk in collecting the full amount. There may also be valid business reasons for an employer to pay off a deferred compensation obligation earlier, such as when it has excess cash, or to reduce a later obligation for credit purposes. 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. It is also a problem that the current severance pay exception is only for involuntary terminations, where in the real world most involuntary terminations are characterized as resignations.²⁰

Further, small employers often prefer to issue stock options at low values as an added incentive to employees. Unlike publicly traded companies (where values can be established based on the stock's traded value), the valuation of any given closely-held company is often open to debate, even among valuation experts. If the exercise price of the stock option is below fair market value as of grant, Section 409A applies. Unfortunately, the uncertain value of closely-held business interests presents a huge risk to a closely-held business considering issuing stock options, as the IRS can challenge the

²⁰ The irony here is that in this instance, the Government would actually receive taxes earlier but for this code section that the IRS has been interpreting in the broadest possible way.

value (even if supported by an independent appraisal), thus exposing the transaction to penalties, interest and additional taxes under Section 409A.

The misplaced application of Section 409A is particularly evident in the personal service organization arena (accountants, architects, dentists, lawyers, nurses, physicians, psychologists, social workers, consultants, etc.), where essentially all of the practice's income is derived from personal services. In such a case, any non-immediate payments to shareholders as compensation or severance pay are subject to scrutiny and immediate tax and 20% penalty if Section 409A is violated. Such violations are often inadvertent and cause no harm.

For example, suppose Medical Practice has several family practice doctors, and one, Dr. Senior, wants to be able to slow down but not fully retire.²¹ Medical Practice values Dr. Senior, who is a valuable resource for the community, and would like him to stay on, but economically needs to limit his pay based on productivity. By contrast, Dr. Senior would like to supplement that income. As an incentive to encourage Dr. Senior, Medical Practice would like to propose to allow him to begin receiving his severance pay, which was to be funded by the collection of his accounts receivable after he retired, when his billings drop below a certain level, but while he was still employed. Medical Practice is advised by its tax advisor that the proposed arrangement would violate Section 409A, as it is not permissible without the imposition of current tax and a 20% penalty to Dr. Senior on money that he would be paid later (but taxed earlier when he was paid unlike the original arrangement, when he would be taxed when paid after retirement).

²¹ For purposes of this example, we have assumed that Dr. Senior wants to work at about 51% of his level of work over the past several years. We have assumed this level to show how Reg. 1.409A1(h) is too restrictive, particularly in the context of phased in retirement planning. This is something the nation should encourage – not discourage.

Clearly, Code Section 409A makes no sense in this situation, as Dr. Senior would be taxed when he received the money. Further, it is very possible that Dr. Senior will simply decide to retire in order to receive his money rather than work at a reduced level of compensation, to the detriment of his patients and the community who value his services as a Doctor.

Section 409A complicates planning for partnerships and other entities (such as limited liability companies treated as partnerships for tax purposes), as the IRS has not yet determined how to address partnership deferrals, due to the conflict between Sections 409A and 736.

There is also a high degree of complexity in determining whether a plan is grandfathered out of the application of Section 409A, or even if so, which part is grandfathered where, for example: (a) there is uncertainty about whether amounts were legally binding; (b) not all amounts are vested; and (c) one of the participants was a controlling owner.

[4] The Sane Course of Action – Exempt Privately Owned Companies From Section 409A Immediately

It is essential that privately owned businesses be immediately exempted from Section 409A before countless dollars are uselessly expended by changing most of the standard operating agreements utilized by privately owned companies. This could best be accomplished by applying a Section 280G like exemption for privately owned businesses with fewer than say 100 owners. Alternatively and not nearly as good, Congress could exempt specific arrangements, such as any buy-sell agreement, salary continuation arrangement for owners who are slowing down (phased in retirement) and

equity positions subject to a vesting schedule of a privately owned company from Section 409A. Existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business. Our nation's privately owned businesses would be far better served if they could take the money they currently will have to spend on tax advisors to cope with Section 409A, and instead invest these funds in making their businesses profitable.

§ 1.04 CAFETERIA PLANS – THE NEW SIMPLE PLAN FOR SMALL BUSINESSES

Tax reform and simplification in the cafeteria plan arena would improve the tax code and greatly assist small businesses. At the same time, some reforms could also assist in bringing health care to many of the nation's small business employees. The most notable of these reforms is the SIMPLE Cafeteria Plan Act of 2007²², introduced by Senator Olympia Snowe and co-sponsored by Senators Kit Bond and Jeff Bingaman. Modeled after the SIMPLE pension plan, Senator Snowe introduced the SIMPLE Cafeteria Plan Act "in order to help small companies increase their employees access to health insurance and other benefits and help them compete for talented professionals."²³

A cafeteria plan is a flexible spending account created by Code Section 125. Very popular with employees, cafeteria plans allow employees to pay for a wide variety of benefits, such as health insurance, child care, care for elderly dependents, or out-of-pocket medical costs, with pre-tax dollars. From among the benefits offered, employees can choose to pay for only those benefits which they want.²⁴ While employers determine

²² S. 555, 110th Cong. (2007).

²³ 153 Cong. Rec. S1858 (Feb. 12, 2007) (statement of Senator Snowe).

²⁴ Employers achieve some tax savings since the employee salary reduction dollars and employer contributions are not taken into account when computing FICA and FUTA taxes.

the benefits to be offered under the cafeteria plan, employees have the flexibility to select only the particular benefits that are of greatest value to them. Thus, flexibility in the selection of benefits and affordability through the use of pre-tax dollars are the hallmarks of the cafeteria plan.

One of the major problems with Code Section 125, however, is that only common-law employees are permitted to use cafeteria plans. Self-employed individuals are not included in the Code Section's definition of "employee."²⁵ As such, sole proprietors, partners in a partnership, shareholders owning 2% or more in a Sub-S corporation, and members of limited liability companies are all excluded from participating in cafeteria plans. This exclusion creates a disincentive for small business owners to offer cafeteria plans to their employees, and this may be one reason why employees of small businesses are three times more likely to be without health insurance than employees of large businesses.²⁶ The SIMPLE Cafeteria Plan Act of 2007 would help to eliminate this unnecessary and punitive distinction by amending the tax code so that small business owners who actually worked for the business could participate in their company's cafeteria plan.

Also proposed by the SIMPLE Cafeteria Plan Act of 2007 are reforms to eliminate the unpopular and unfair "use it or lose it" policy now applicable to flexible health care accounts. This would be another positive step towards simplifying the tax code. The "use it or lose it" policy basically means that if an employee has overestimated

²⁵ See 26 U.S.C. § 125 (2007).

²⁶ In 2004, according to the Employee Benefit Research Institute, a non-partisan health policy group, nearly 63% of all uninsured workers were either self-employed or working for private-sector firms with fewer than 100 employees. In comparison, only 13.4% of workers in firms with more than 1,000 employees do not have health insurance. 153 Cong. Rec. S1857-58 (Feb. 12, 2007)(statement of Senator Snowe).

the amount of health care expenditures that he or she will have to pay during the year (over and above those paid by health insurance) then the excess amount is forfeited to the employer. Employers are prohibited from “bonusing” this amount back to the employee who forfeited his or her own money. Some employers apply these forfeited amounts to benefits for all the employees in the following year, but there is no requirement that they do so.

Theoretically, the policy behind this unpopular rule created by the IRS was to make the flexible health care account be more like an insurance policy. The absurdity of this argument is easy to see – it is hard to imagine someone purchasing an insurance policy where the risk is limited to the amount of “premiums” paid and the insured party forfeits their own money if they cannot come up with enough expenses. Thus, comparing the “use it or lose it” rule of a medical reimbursement account under a flexible spending arrangement to health insurance (or any other kind of insurance) is ridiculous. Regardless of where this idea came from, it is a bad idea. It is unfair to employees and runs counter to public policy inasmuch as employees generally will not save as much as they are able to pay for health care expenditures because they are fearful of forfeiting their own money (their savings for health care expenditures) to their employer.

The flexible health care account should be treated more like its sister benefit – the dependent care flexible account. By capping the amount of the health care flexible spending account similar to the way dependent care account is capped, there is no need to fear that the account could be subject to abuse. These changes would encourage employees to select the appropriate amount required for health care expenditures rather than possibly choosing to estimate low so that they do not forfeit their own money to

their employer. Furthermore, it would assist employees in dealing with rising health care costs and provide a vehicle for them to save for these expenditures in a tax free manner.

There have also been efforts to change the overly complex and unfair nondiscrimination rules applicable to cafeteria plans. Each underlying benefit offered under a cafeteria plan is tested, in accordance with the rules set forth in the tax code for that particular benefit, to make sure it is not discriminatory. Paradoxically, benefits bundled together in a cafeteria plan are subject to yet another layer of discrimination tests simply because the benefits are offered under a cafeteria plan umbrella. While concern for abuse is undeniably a legitimate concern, it is hard to imagine a plan less discriminatory than a cafeteria plan.

It follows that these rules are doing little more than adding clutter to the tax code. Despite any genuine intent and concerns behind the nondiscrimination rules, their effect is undeniably detrimental. The nondiscrimination rules are another one of the primary reasons small businesses often choose to not provide cafeteria plans. Because of their size, small businesses are usually unable to satisfy the nondiscrimination rules. In other words, rather than ensure that benefits are available to all employees, the nondiscrimination rules, particularly in the context of small business, often result in benefits being available to none.

The SIMPLE Cafeteria Plan Act of 2007, if passed, would streamline the tax code by eliminating some of these rules. Under this Act, there would be a safe harbor for satisfying the nondiscrimination rules in exchange for making a required annual contribution of 2% or a matching contribution of 3% to employees' accounts for health insurance and other employee benefits (very similar to the popular SIMPLE retirement

plan for small businesses). With this safe harbor in place, none of the discrimination tests applicable to cafeteria plans and dependent care plans would apply, thereby eliminating these unnecessary complex rules from the tax code.

Eliminating these rules will further enable more small businesses to provide cafeteria plans for their employees. Small businesses have demonstrated that they are willing to absorb some additional costs for employees in the way of required contributions in exchange for relief from complex administration and discrimination tests with the widespread acceptance of the SIMPLE pension plan. It is anticipated that the safe-harbor cafeteria plan patterned on the SIMPLE retirement plan would also be accepted and adopted by small business.

Furthermore, in addition to simplifying the tax code, the SIMPLE Cafeteria Plan Act of 2007 could go along way towards resolving some of the problems facing our healthcare system. It is no secret that millions of Americans are forced to live either without health insurance or with insurance, but underinsured. Small businesses are the driving force behind our nation's economy and they employ millions of its citizens, yet employees of large businesses are three times more likely to have health insurance than employees of small businesses. What is more is that not only are employees of large businesses more likely to have health insurance, but they are also likely to pay a lot less for that insurance. The SIMPLE cafeteria plan would help in reducing the number of uninsured and underinsured Americans by enabling small businesses and their employees to be able to purchase employer-provided health insurance with pretax dollars. Even though some may argue that this loss of revenue is expensive, any loss of tax revenue should be weighed against the money the government would ultimately save as more and

more Americans are actually able to afford to cover their own health insurance without government entitlements or subsidies.

This legislation would also permit cafeteria plans to provide for long term care insurance benefits. Under current law, the benefits that may be offered through a cafeteria plan include: accident or health plan coverage, including traditional group health insurance; insurance through HMOs or PPOs; self-insured medical reimbursement plans; accidental death and dismemberment policies; hospital indemnity policies; cancer insurance policies; short and long term disability policies; Medicare supplemental coverage and Medicare Part B premiums; employee contributions under a workers' compensation act; prepaid vision, prepaid prescription drugs; prepaid discount plans; group term life insurance; adoption assistance; 401(k) cash or deferred arrangements; paid vacation days; and paid time off (rarely included because of administrative problems). Long term care insurance, medical savings accounts, qualified scholarships, educational assistance programs, and fringe benefit programs are all expressly excluded. But of these benefits expressly excluded from cafeteria plans, long term care insurance is perhaps the most troubling.

Cafeteria plans should be able to provide employees with long term care insurance. By allowing employees to purchase this valuable benefit on a pre-tax basis and by payroll deduction, it is far more likely that employees will elect to be covered by long term care. It is also more likely that they will select long term care when the policy has been "pre-selected" by the employer for them. This change would encourage more employees to finance their own long term care. It is desirable to shift as much of the burden of providing for the long term care needs of the baby boomer generation over to

them rather than having to be taken care of by the government. The more the government can incentivize individuals to purchase long term care insurance on their own the better.

In addition to simplifying the tax code, the SIMPLE Cafeteria Plan Act of 2007 addresses pressing healthcare issues facing the United States. It is essential that the government incentivize individuals to undertake as much of the burden of providing for their healthcare as possible. Passing legislation like the SIMPLE Cafeteria Plan Act of 2007 will allow small business employees to join their counterparts in mid and large businesses and to save for health care and other employee benefits in a tax advantaged manner. Furthermore, it just makes sense for all employees, regardless of the size of the entity they work for, to be able to have access to the same benefits under the tax code.

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 provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Advisory Boards.