



SBCA SUPPORTS LIMITING CODE SECTION 409A TO PUBLIC COMPANIES

The Small Business Council of America (SBCA) urges Congress to limit the application of Internal Revenue Code Section 409A to publicly traded companies. Congress enacted §409A in response to the abuses seen in the Enron, WorldCom, and similar scenarios. Its goal in creating this statute was to protect investors 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, costly 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. ***Accordingly, SBCA respectfully requests that Congress revise §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.***

Section 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 very complex rules. All plan documents were required to be in compliance with the final §409A Treasury regulations by December 31, 2008. If these rules are violated, the amounts involved 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 shareholders. This abuse simply does 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 because they are generally the same people. 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 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 deferring compensation, whether or not intended by the parties to do so. The effect of this is that owners of closely-held business were required to have advisors review, among other things, their employment agreements, severance pay 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. Thus, §409A forced and will continue to force small businesses to spend a great deal of money on unnecessary legal and accounting expenses. This arcane tax code section prevents common sense economic arrangements that are sensible for the employees and businesses and pose no opportunity for abuse.

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 very broadly in its nearly 400 pages of regulations, §409A has developed into the very antithesis of simplification. As noted above, all businesses were supposed to have all of their operational documents in compliance with §409A by the end of 2008, regardless of the income tax year end. Furthermore, the IRS has announced that it will not provide advance rulings on §409A issues, leading many to believe that taxpayers are being required to comply with an area the IRS does not even understand well enough to rule on. Those small businesses fortunate enough to have advisors who are even aware of this new tax code section at least attempted 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.

Additionally, 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 it is 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.

The §409A rules impose income tax on the employee or independent contractor plus a 20% penalty. In addition, the employer must report and withhold tax or it too is subject to penalties. All plans had to operate in compliance with §409A by January 1, 2005 and written and operational compliance with the final §409A Treasury regulations by

December. 31, 2008, regardless of the employer's tax year. The problem is that these rules impose very complex rules not yet understood by most small businesses and their advisors. Even worse, while aimed at WorldCom and Enron executives who took substantial deferred compensation payments at the expense of the companies and their shareholders, these rules do not curb any abuse in small business because the interests of the owners and the businesses are aligned. Yet the tax applies to small business owners and employees, even though there is no abuse. Even worse, the tax can and will apply twice on the same money, an extremely onerous result.

Let's assume that a sales business or professional practice pays an employee who cannot do his job for three months – a self funded "own occupation" short term disability plan. Let's also assume that the same sales business or professional practice pays a terminated employee 80% of the collections of his or her accounts receivable for the twelve months after his or her termination of employment, less any prior disability payments. If in 2009 this agreement is not in writing, the tax consequences apply. If it is in writing, the employees are also taxed in 2009 because this own occupation disability is not a permissible §409A payment event (only permanent and total disability is) and thus the offset of the severance pay by this own occupation disability is not a permitted offset. Thus, in either case, the business must report and withhold on this taxable income, and the employee must pay the tax and the 20% penalty. There is no abuse here that warrants this treatment but that is the way the rules under the final regulations work.

In addition, the employee would be taxed on his or her regular compensation, which is funded by sales or professional services collections less overhead expenses. In effect, the employee is taxed twice on the same money. Furthermore, assume that this employee terminates employment five years later and receives severance pay. The employee would be taxed on that when paid as well.

Section 409A also prohibits renegotiation 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 to the employee or independent contractor. There may be valid business reasons for an employer to pay off a deferred compensation obligation earlier. This would violate both the rule against acceleration and the rule that payments must be a specified amount on a specified payment schedule on termination of employment or change of control.

Another issue surfaces where small employers issue stock options as an added incentive to employees. Section 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). While §409A does not apply to incentive stock options, in effect it does because employers issuing incentive stock options are allowed to use a good faith determination of fair market value whereas 409A has a different standard

that in effect requires an independent third party appraisal, a costly burden for a small business, since the appraisal's cost can easily be \$10,000 to \$50,000.

The consequences of noncompliance with §409A are out of proportion to the violation. A single violation can trigger inclusion of all compensation deferred under a plan for the year of the violation and all preceding tax years. In addition, under the aggregation rules, amounts deferred under other plans of the employer can also be included in income. For small business, we are seldom talking about §409A's application to deferrals but rather on severance pay. But the consequences are the same.

In short, existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business, where Enron-type abuses do not occur due to the identity of ownership and management, who are often the same people. To remove small business from these burdensome rules ***Congress should create an exemption for (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.***

Small businesses and our Nation's economy would be better served if they could take the money they will have to spend on tax advisors and appraisers 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 three average years of income over the last five years and it pays this obligation to the doctor in equal amounts over a five 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.

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. The SBCA has many

of the country's leading small business tax, healthcare and employee benefit advisors included on its Board and Advisory Boards.

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