April 2013

Comments to the U.S. House of Representatives Committee on Ways and Means Working Groups on Pension/Retirement and Small Businesses

On Section 409A

Chairman Camp, Ranking Member Levin and Members of the Committee, the Small Business Council of America (SBCA) appreciates the opportunity to share its insight on the relationship between 409A and small business and comment on the potential impacts of tax reform on small business.

Section 409A of the federal tax code was designed to stop public companies like Enron and Tyco from manipulating deferred compensation to avoid creditors and obtain lower tax rates. Instead, 409A has brought onerous penalties and excessive compliance costs to small businesses such as software engineers who may be paid only when their employer has cash, construction foremen who are awarded bonuses that are paid after the year earned, employees of technology start-up companies that are initially compensated with stock options with a low option price and campaign workers who may not be paid for work until after the end of the campaign.

Background of 409A

Congress added Section 409A to the tax code in 2004 primarily to stop manipulation of deferred compensation by executive officers of public companies who seized tax and payment advantages denied to other employees lacking influence or power. These methods included acceleration of payment and offshore funding to avoid an employer's creditors and deferral of payment to coincide with low tax years.

Even though aimed at public companies, Section 409A was not limited to them but instead encompassed all businesses however small. As a result, 409A is disproportionately complex relative to its stated goals to discourage specific abuses but raise no revenue. A simple SEC rule to limit executive compensation would have been a more focused and effective remedy for improper manipulation of the timing and funding of compensation.

Even though a stated purpose of 409A was to penalize manipulation of the timing of compensation, 409A does not prohibit an employer from reimbursing the employee under a separate agreement for any 409A penalties or interest incurred by the employee which arise from a violation of 409A.

When enacted, the expected tax revenue to be derived from 409A was near zero because it was assumed that the tax and penalties would induce compliance.

Scope of 409A

- 409A broadly defines deferred compensation as any compensation earned in one year and paid in a later year.

- 409A applies to all companies, from Microsoft and General Motors to independent software designers and structural engineers.

- 409A applies to all deferrals from multi-million dollar bonuses for CEOs to delayed payment of salaries by owners of cash-strapped service businesses.

- 409A applies to executives who elect to defer receipt of million dollar salaries and to consultants who must wait to collect accounts receivable for current work done.

- Income tax on deferred compensation will be deferred under 409A only if the time and method for its payment are fixed by a written agreement at the time compensation becomes legally binding and vested.

- Income tax on deferred compensation will be accelerated and penalties imposed if (a) any term of the written agreement, no matter how technical, fails to comply with 409A or (b) the operation of the written agreement does not comply with the agreement or with 409A.

- The IRS has provided a correction procedure for a few of the more likely violations, but most corrections require at least a partial payment of tax and penalties.

Tax and Penalty

409A imposes income tax and adds a draconian 20% penalty on the deferred compensation for any violation of 409A even where promised compensation was not funded by or available from the employer. Moreover, the 20% penalty is imposed on the amount of deferred compensation and not the amount of tax, unlike for most other tax penalties.

The tax and penalties for 409A violations are imposed on the employee, not the employer. This is because the law was designed to stop executives of public companies from gaining unfair advantages. Most deferred compensations arrangements, however, are created by employers. Except for top executives, employees with deferred compensation have no control over the employer's compliance with 409A but bear all the tax and penalty burdens of non-compliance.

Some states (e.g. California) have adopted 409A in full, thus adding an additional 20% penalty on the amount of compensation. Federal and State tax and penalties, plus interest, could therefore total nearly 100% of the promised deferred compensation without any receipt of cash to pay those obligations.

While 409A is aimed at employees, an employer also can be penalized for failing to withhold income and payroll tax on compensation taxed on a violation of 409A. The penalties can exceed 40% of the tax plus interest.

Costs to Comply with 409A

While the law applies to both rich and poor equally, the costs to comply are not in proportion to the amount of compensation. Employers cannot comply with 409A without sophisticated accountants, lawyers and other advisors. Further, even though 409A has been in effect for over eight years, many employers (perhaps more than half) and certainly most employees remain unaware that 409A applies to arrangements that are not conveniently labeled as "deferred compensation." For example, 409A applies to severance pay arrangements, accrued bonuses, retiree health benefits, non-qualified retirement plans, phantom stock plans, payments based on future collections and payments due but delayed for economic reasons.

The minimum costs of compliance are in the thousands if not tens of thousands of dollars, irrespective of the amount of compensation deferred. In fact it is less costly to comply with 409A for deferral of a million dollar bonus for an executive than it is to comply for a separation pay plan for a group of employees in a small business. The principal costs are for legal and accounting services to analyze the facts and law and prepare the required written agreement.

Solutions to Current Law

The best solution is to make the scope of the law consistent with its original objectives by amending 409A to apply only to key employees of public companies who are in the best position to manipulate the timing of their compensation and whose companies can afford the costs of compliance.

At a minimum the penalty amount should be consistent with those for violations of other similar tax rules by applying the penalty to the tax and not to the amount of compensation. As noted above, a violation for a California employee in the federal tax bracket of 28% and California bracket of 10.3% could be a total tax and 409A penalty of nearly 70% plus retroactive interest even though no amount has been paid to the employee.

Another possible solution is to tax compensation at the same tax rate in effect in the years of deferral so that an acceleration or further deferral will not give the employee an income tax advantage based on his or her tax situation in the year of payment. Of course, this solution at least solves the problem of an employee being taxed on "deferred income" which will never be paid to him or her. In the small business context, this is perhaps the most troubling aspect of the application of 409A – small business employees being taxed and having penalties imposed on "compensation" that they may never receive.

Tax Reporting

409A required that employee deferrals under a nonqualified deferred compensation plan would be subject to reporting on IRS Form W-2. For reasons not explained by the IRS, it has continued to defer this requirement, with the result that tax preparers were never induced to get on their horses and warn taxpayers that 409A penalties were coming so that current ignorance of the law is vast.

The SBCA thanks this Committee for its consideration of these issues and would welcome the opportunity to discuss these comments further.

The Small Business Council of America (SBCA) is a national nonprofit organization which has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters since 1979. 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.

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