Nonqualified Deferred Compensation Plan Sponsors: COVID-19 Pandemic Considerations

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This Alert discusses certain considerations for employers that sponsor nonqualified deferred compensation plans, in light of business/market conditions and employee needs resulting from the COVID-19 pandemic, with a particular emphasis on the strict requirements of IRC § 409A.

Unintended 409A Arrangement

Many employers are temporarily reducing pay of employees due to the COVID-19 pandemic.[1] To the extent that such an employer promises to make up the reduced pay in the future, that promise could very well be a nonqualified deferred compensation arrangement subject to 409A (including penalties for noncompliance). The factors that could affect whether such an arrangement is subject to 409A and, if so, whether the arrangement is compliant include whether the promise of future payment is subject to a continuous employment requirement, the timing of the future payment, and whether the employee otherwise participates in a deferred compensation plan maintained by the employer. Any employer contemplating such a deferred payment arrangement should confer with experienced counsel.

Cessation of Deferrals

Generally, under 409A, an employee's election to defer salary under a nonqualified plan must be made before the beginning of the service year. Employees generally cannot cancel such an election midyear. One of the exceptions to this general rule is the occurrence of an unforeseeable emergency with respect to the employee. An unforeseeable emergency is a severe financial hardship to the employee resulting from an illness or accident of the employee, the employee's spouse, the employee's beneficiary, or the employee's dependent; loss of the employee's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the employee. The COVID-19 pandemic may or may not constitute an unforeseeable emergency for a given employee, depending on how the employee is impacted. Importantly, employers should **not** assume that a participant who is eligible as a "qualified individual" to receive a penalty-free COVID-19 distribution under the CARES Act tax-qualified plan rules has necessarily suffered an unforeseeable emergency that would permit a midyear cancellation of a deferral election under a nonqualified plan (for example, an employee whose spouse has been diagnosed with COVID-19 would be considered a qualified individual under tax-qualified plan rules, but that does not necessarily mean the employee has suffered a severe financial hardship that permits the employee to cancel a nonqualified plan deferral election). Further, employers should keep in mind that any cancellation of a deferral election due to an unforeseeable emergency must apply for the remainder of the year, not merely a portion of the remainder of the year (for example, an employee could not cancel a salary deferral election for April through June and then resume deferrals for July through December).

Early Distributions

Subject to limited exceptions, under 409A, the timing of payment of nonqualified deferred compensation cannot be accelerated from the originally scheduled payment date under the plan. Similar to the above with respect to a midyear cancellation of a deferral election, one of the exceptions to the prohibition on acceleration of payment is the occurrence of an unforeseeable emergency. Such a distribution may not be made to extent that the emergency is or may be relieved through reimbursement or compensation from insurance or otherwise; by liquidation of the employee's assets (to the extent the liquidation of such assets would not cause severe financial hardship); or by cessation of deferrals under the plan. Again, employers should **not** assume that a participant who constitutes a qualified individual under the CARES Act tax-qualified plan rules has necessarily suffered an unforeseeable emergency that would permit early payment of nonqualified deferred compensation.

Separation from Service as a Payment Triggering Event

Many nonqualified plans provide for payment upon a "separation from service." Depending on how they are structured, furloughs, leaves, layoffs, and hour reductions may not qualify as a separation from service. Under 409A, the employment relationship is treated as continuing intact while the employee is on sick leave or other bona fide leave of absence if the period of such leave does not exceed six months or, if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract. A leave of absence constitutes a bona fide leave of absence only if there is a reasonable expectation that the employee will return to perform service for the employer. Further, whether a separation from service has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date would be permanently decreased to no more than 20 percent of the average level of bona fide services performed over the preceding 36 months. Therefore, a furlough generally would not be considered a separation from service triggering payment under a nonqualified plan. In addition, a technical termination of employment (in lieu of a furlough) in which the employer and employee expect that the employee will be rehired generally would not be a separation from service triggering payment under a nonqualified plan. If, at a later date, the employer and employee come to reasonably anticipate that the employee's services will cease (or be substantially reduced) permanently, then that would constitute a separation from service.

Payments Made upon Separation from Service

Where the amount of nonqualified deferred compensation to be paid to the employee is based on the value of the employer's stock or other specified investments, an employee who is scheduled to receive a payment in the near term may wish to delay payment until the employer or market recovers from the COVID-19 pandemic. However, under 409A's strict rules regarding changes in timing of payment, an employee's election to delay payment generally cannot take effect until at least 12 months after the date the change is made (and payment must be delayed for at least five years from the date on which the payment otherwise would have been made). Therefore, as a practical matter, an employee who is laid off during the COVID-19 pandemic cannot further defer payment with the hope of receiving a higher payout based on improved business or market conditions. For a public company, the required six-month delay for payout to a “specified employee” in connection with a separation from service may be beneficial to the employee, assuming the account balance continues to be adjusted during the six-month period. For a private company plan that provides for payout based on the most recent annual valuation of company stock (e.g., RSUs), an interim valuation under the plan may be advisable (if permissible under the terms of the plan) to prevent the employee from obtaining a “windfall” from payment being calculated based on a pre-COVID-19 valuation.

Potential Ability for Employer to Delay Payment

While an employee, at this point, generally will not be able to elect to further defer payment of nonqualified deferred compensation that is scheduled to be paid this year (e.g., upon separation from service), an employer looking to allocate resources to purposes other than payment of nonqualified deferred compensation may have some flexibility to temporarily delay payment. Under 409A, if the making of a payment at a date specified under the plan would jeopardize the ability of the employer to continue as a going concern, the payment can be delayed by the employer so long as the payment is made during the first taxable year of the employee in which the making of the payment will not have such effect (for a payment that would otherwise qualify as a “short-term deferral” exempt from 409A, the payment would need to be made as soon as the payment would no longer have such effect). In addition, regardless of whether the payment would jeopardize the ability of the employer to continue as a going concern, and depending on the terms of the plan, the employer may be able to delay payment until later this year, as 409A generally permits payment to be made at a later date that is in the same taxable year of the employee. In either case, the employer would need to check the terms of the particular plan to determine whether the delay can occur as a contractual matter.

[1] While this Alert focuses on the employer-employee relationship, it should be noted that IRC § 409A (and many of the rules described in this Alert) also applies to independent contractors. Further, this Alert does not address the potential impact on nonqualified plans of the CARES Act compensation restrictions applicable to officers and employees of certain businesses (e.g., those that receive loans, guarantees or other investments from the government pursuant to Section 4003(b) of the CARES Act).