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Employee Benefits & Executive Compensation

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Deferred Compensation Considerations in the Wake of the COVID-19 Pandemic

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As the COVID-19 pandemic continues to unfold, both employers and employees are faced with liquidity issues, furloughs, layoffs, and the reduction of hours. In order to conserve cash, employers may be looking for ways to delay payments of deferred compensation and employees may be looking for ways to accelerate the payments of deferred compensation. Employers and employees alike may also be questioning whether payments of nonqualified deferred compensation are due to be made to an individual who is furloughed or laid off, or whose hours have been reduced.

The rules of Section 409A of the Internal Revenue Code of 1986, as amended, which govern the time and form of payment of nonqualified deferred compensation, are complex and impose strict limitations. Failure to comply with Section 409A could lead to accelerated income tax, excise tax, interest, and penalties on the employee, or liability for failure to report compensation and withhold taxes on the employer. To avoid these undesirable consequences, employers should ensure that they are complying with the rules of Section 409A.

Any current reduction of compensation in exchange for some other right to future compensation may implicate Section 409A. For example, if a company agrees with an executive midyear in 2020 to reduce his or her compensation for the remainder of 2020 in exchange for payment of the forgone salary and/or bonus plus interest in a future tax year, it could trigger adverse tax consequences for the executive under Section 409A. There are ways to structure such an arrangement to avoid adverse tax consequences, but as is often the case, the arrangement must be carefully structured so as to ensure compliance with the tax rules.

Permissible Delay: ‘Going Concern’

Employers who seek to further delay an existing deferral of compensation already subject to Section 409A will need to consider carefully what limitations and exceptions may apply under Section 409A to allow for such a delay. If making a payment of deferred compensation “would jeopardize an employer’s ability to continue as a going concern,” Section 409A permits the employer to delay making the payment until the company’s financial viability is no longer in jeopardy. If the payment is made during the first taxable year in which the company’s financial viability is no longer in jeopardy, it will be treated as being made at the time specified by the arrangement. For payments structured as short-term deferrals under an exception to Section 409A, the rules similarly permit a delay in payment (if paying would jeopardize the employer’s ability to continue as a going concern) as long as payment is made as soon as reasonably practical once the employer no longer has such financial concerns.

The determination of whether making a payment would have jeopardized the employer’s ability to continue as a going concern is likely based on the applicable facts and circumstances. It appears the concept is intended to be broader than insolvency; for example, it could include breach of a loan covenant. However, there is little guidance on how to apply this exception. In addition, while Section 409A may permit a delay in these circumstances, if the applicable contract or plan does not permit such a delay, an employer could be in breach of its contractual obligation to make a payment.

Permissible Accelerations: Short-Term Deferrals and 'Unforeseeable Emergency'

In this difficult and uncertain economic environment, employees may be looking to accelerate payments that otherwise would not yet be due, including amounts that have been previously deferred. Section 409A generally prohibits employers from paying deferred compensation earlier than scheduled. However, certain compensation arrangements are excluded from the definition of "deferred compensation" under Section 409A and, as such, are not bound by the same strict limitations that apply to "deferred compensation" under Section 409A.

Most notably, payments that are considered "short-term deferrals" (compensation required to be paid out in the year vesting occurs or within two and a half months after the end of that year) are exempt from Section 409A. This means that certain short-term deferral payments that normally would be paid at a later date may be paid early without triggering adverse tax consequences under Section 409A. For example, if an employment agreement provides for a bonus to be paid on March 1, 2021, if the employee continues in employment through December 31, 2020, the employer can accelerate payment of the bonus to a date in 2020 without running afoul of Section 409A.

A comprehensive discussion of compensation arrangements that are exempt from Section 409A (such as separation pay plans and qualified deferred compensation) is beyond the scope of this summary.

Unforeseeable Emergency

If it is permitted by the applicable arrangement, an employee may be eligible for an early distribution of nonqualified deferred compensation in the event of an unforeseeable emergency. Under Section 409A, an unforeseeable emergency is defined as "a severe financial hardship to the employee resulting from an illness or accident of the employee (or his/her spouse or a dependent), or loss of the employee's property due to casualty or other similar extraordinary unforeseeable circumstances arising as a result of events beyond the control of the employee." While this is a "facts and circumstances" determination, it is not difficult to imagine that economic hardships related to the COVID-19 pandemic could be considered an unforeseeable emergency.

In addition to receiving early distributions of deferred compensation on account of an unforeseen emergency, an employee also may cancel (but not postpone or delay) a previously made deferral election, which is otherwise irrevocable.

Distributions due to unforeseeable emergencies must be limited to the amount reasonably necessary to satisfy the emergency and pay taxes reasonably anticipated to result from the distribution, and they may not be made to the extent the emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets (to the extent liquidation would not cause severe financial hardship), or by ceasing deferrals under the plan. This restriction makes early distributions of deferred compensation a less viable option for employees struggling with COVID-19-related financial hardships.

If a plan does not currently provide for payment upon an unforeseeable emergency, it can be amended to add such a provision at any time before payments are made to employees. Employers should review their nonqualified compensation plan documents and consider amending arrangements to permit such distributions.

Payments Upon a 'Separation From Service'

Many nonqualified deferred compensation plans provide for payments or certain benefits (e.g., accelerated vesting) to employees upon a separation from service. With the increase of furloughs, reduced hours, and layoffs due to COVID-19, many companies have been left wondering whether an employee has incurred a separation from service.

In general, under Section 409A, an employee incurs a separation from service on the date after which the parties reasonably anticipate that the employee will perform no services or the level of bona fide services the employee will perform will permanently decrease to no more than 20 percent of his or her past service. The determination of whether a separation from service has occurred, including in the case of furloughs, is based heavily on the facts and circumstances of each employee.

A furlough alone generally does not constitute a separation from service, since the parties typically intend to resume employment once the financial conditions have improved. A separation from service does not occur where an employee is on a bona fide leave of absence, which means (i) there is a reasonable expectation that the employee will return to work; and (ii) the leave period is six months or less or, if the leave period is more than six months, the employee retains a right to reemployment by contract or under applicable law. In some circumstances, once an employee has been on a leave of absence (or furloughed) for more than six months with no anticipated date for return to employment, he or she will have incurred a separation from service for purposes of Section 409A.

Note that if a plan or agreement provides an employee with a right to nonqualified deferred compensation but the specified payment dates or events do not include a separation from service, Section 409A would not permit the deferred compensation to be paid upon a separation from service.

Proposed Legislative Relief

As of the date of this client alert, there are no proposed changes to the rules of Section 409A as a result of COVID-19.

The rules of Section 409A are very complex and highly technical. Employers should consult with legal counsel before accelerating or delaying any payments subject to Section 409A, and to determine whether any nonqualified deferred compensation payments are due as a result of a change in employment status.

To see our prior alerts and other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking here.

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