# COVID-19: Impact on Nonqualified Deferred Compensation Plans

April 29, 2020

The coronavirus (COVID-19) pandemic and the ensuing market uncertainty, as well as recently enacted legislation, have upended the compensation and benefit programs of many companies. This is the fourth memorandum in a series of client memoranda that we are preparing regarding how companies may wish to consider addressing their programs in this context.[1]

Recent economic instability caused by the COVID-19 pandemic has caused many companies and their employees to suffer economic hardships that do not have a clear end in sight. As a result of ongoing fluctuations in the markets, uncertainty about job security and increased medical and other expenses, people are experiencing a real need for increased liquidity in the short term. As a result, companies that maintain nonqualified deferred compensation (NQDC) plans may be approached by employees seeking to take distributions of deferred compensation from their plan accounts or to cancel or suspend currently outstanding deferral elections under the plan.

The challenge for both companies and their employees is that the payment of nonqualified deferred compensation is subject to Section 409A of the Internal Revenue Code (Section 409A), which was enacted in 2004 partly in order to prevent the accelerated payment of deferred compensation amounts, particularly when a company is in financial distress or on the eve of bankruptcy. Since the rules under Section 409A (the Section 409A Rules) were designed to address these concerns and generally prevent the early payment of NQDC plan accounts, they often fail to provide needed flexibility in a crisis like we are experiencing today.[2] The Section 409A Rules are technical, complex and prone to foot faults. In addition, most determinations as to whether exceptions under the Section 409A Rules apply are highly fact dependent both on a company and an individual employee basis. Most importantly, a failure to comply with the Section 409A Rules has **draconian consequences to the affected employee**: if payments of nonqualified deferred compensation are made in violation of Section 409A, then the **employee** will be required to pay an **additional 20% tax**, on top of the ordinary income taxes on the

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[1] Please see our previously published client memoranda: **COVID-19: Considerations for Companies That Have Not Yet Established Their 2020 Incentive Compensation Programs**, **COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs** and **COVID-19: Addressing Underwater Options and Stock Appreciation Rights**.

[2] As a general rule, Section 409A permits the payment of deferred compensation only in connection with one of the following events:

(i) an employee's separation from service;
(ii) an employee's death or disability;
(iii) on a specified date or pursuant to a fixed schedule;
(iv) a change in control of the company; or
(v) due to an unforeseeable emergency.

Treas. Reg. § 1.409A-3(a). This memorandum focuses specifically on whether payments from NQDC plans may be made in light of the COVID-19 pandemic as a result of an unforeseeable emergency or reduced work circumstances, such as furloughs, that may qualify as a separation from service.

noncompliant deferred compensation amount and underpayment penalties.[3] For these reasons, companies seeking to assist struggling employees should carefully consider each individual circumstance in light of the relevant provisions of the Section 409A Rules in order to avoid causing inadvertent harm to already struggling employees.

While it would be within the powers of the IRS to amend or clarify these rules to provide relief to employees during this challenging time and while we understand that there has been some outreach to the IRS, the agency has not made any affirmative changes or announced any openness to creating even temporary relief at this time. As a result, this memorandum discusses various approaches that companies may be able to utilize within the current Section 409A landscape to provide their employees some relief by allowing them to take distributions of, or cancel deferral elections with respect to, nonqualified deferred compensation.[4]

## Taking Distributions of Nonqualified Deferred Compensation

The first three questions in this memorandum address the considerations companies should keep in mind when assessing whether Section 409A would currently allow employees to take distributions of nonqualified deferred compensation as a result of either an "unforeseeable emergency" or circumstances such as a furlough, that may constitute a "separation from service" for Section 409A purposes. For companies in distressed financial conditions that may be contemplating a bankruptcy proceeding, refer to Question 10 below for some additional considerations that may arise in the bankruptcy context.

### 1. Does the COVID-19 pandemic create a permissible payment event by qualifying as an "unforeseeable emergency"?

**Maybe**. While the Section 409A Rules include a broad catch-all exception for emergency financial needs, and while it is possible that economic and financial hardships resulting from the COVID-19 pandemic may fit within this exception, which is referred to as an "unforeseeable emergency", even if it is determined that an unforeseeable emergency exists, Section 409A imposes an **additional hurdle** before employees can actually take distributions from their account balances due to the unforeseeable emergency.

While the determination of whether an unforeseeable emergency exists is "based on all the relevant facts and circumstances of each case", including on an individual employee basis, the Section 409A Rules define an unforeseeable emergency as the occurrence of:

- a severe financial hardship resulting from an illness or accident;
- the loss of property due to casualty; or
- other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the employee's control.[5]

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[3] The additional 20% tax will apply to both the noncompliant deferred compensation amount as well as any other amounts that would be aggregated with such amount under Section 409A's plan aggregation rules. We provide an overview of the plan aggregation rules in Question 7 below.

[4] This memorandum focuses on nonqualified deferred compensation only, and generally does not address considerations relating to qualified deferred compensation plans, such as 401(k) plans.

[5] Treas. Reg. § 1.409A-3(i)(3)(i). Examples specified under the Section 409A Rules include the imminent foreclosure of or eviction from an employee's primary residence or the need to pay for medical or funeral expenses.

We expect that much of the severe financial hardship caused by the COVID-19 pandemic for many individuals, including, in particular, those facing foreclosures or evictions and those concerned about medical or funeral expenses, would constitute an unforeseeable emergency under the Section 409A Rules. Unfortunately, distributions on account of an unforeseeable emergency "may not be made to the extent that such emergency is or may be relieved" by one of the following other sources:[6]

- reimbursement or compensation from insurance or otherwise;
- liquidation of assets to the extent the liquidation would not itself cause severe financial hardship; or
- cessation of deferrals under the NQDC plan.[7]

Because of this additional hurdle, an early plan distribution is likely more of a last resort, rather than the first resource a struggling employee will be able to access. Accordingly, depending on an employee's individual financial circumstances and the availability of other forms of compensation, taking a distribution may be a less realistic option under Section 409A than canceling currently outstanding deferral elections (discussed in Question 4 below) or seeking funds from other sources.

### 2. Are there other considerations for companies if an employee elects to take a distribution on account of an unforeseeable emergency?

**Yes**. Companies should keep in mind the following additional considerations when contemplating whether to approve an employee's distribution on account of an unforeseeable emergency:

- **The amount of payment is limited to the employee's need**. If a company does decide to approve the distribution, Section 409A requires that the amount of the distribution "must be limited to the amount reasonably necessary to satisfy the emergency need," inclusive of any associated taxes.[8]
  - The Section 409A Rules provide that this determination should take into account, as noted above, any additional compensation that becomes available to the employee as a result of canceling deferral elections under the NQDC plan, but does not need to account for any additional compensation that may become available to the employee under a tax-qualified plan (for example, by taking a loan under a 401(k) plan) or another NQDC plan.
- **Review plan documents before making any distribution payments**. Companies should review the terms of their NQDC plan documents to confirm whether an unforeseeable emergency is a specified payment event under the plan. If the plan does not currently provide for payment upon an unforeseeable emergency, then the plan will need to be amended, which may be done at any time, before any payments are made to employees.[9]
- **Companies may exercise discretion.** Even if an employee satisfies Section 409A's requirements for taking a distribution on account of an unforeseeable emergency as described

[6] We note that many federal, state and local agencies are taking measures to halt or provide relief from foreclosures and evictions during the pandemic, including under the CARES Act and in states such as New York, California, Florida and Massachusetts. In addition, some states, including New York, are considering measures to ease the burdens of medical expenses caused by the pandemic.

[7] In Question 4 below, we discuss the possibility of canceling deferral elections as a result of the COVID-19 pandemic.

[8] Treas. Reg. § 1.409A-3(i)(3)(ii).

[9] Treas. Reg. § 1.409A-3(i)(3)(ii).

above, Section 409A allows companies to exercise discretion on whether or not to make the payment available. Some companies may consider other ways of providing relief to their employees.

### 3. May furloughed employees take distributions of deferred compensation on account of a "separation from service"?

**Maybe, but probably not**. The COVID-19 pandemic has caused many companies to impose furloughs or other temporary leaves of absence on their employees and questions may arise as to whether these leaves of absence would trigger distributions of NQDC plan account balances due to an effective termination of employment. Whether employees will be able to take distributions of deferred compensation as a result of a furlough will depend heavily on the facts, specifically, whether the furlough or leave constitutes a "separation from service" within the meaning of Section 409A. This is a facts-and-circumstances determination, and the following principles apply:

- leaves of six months or less or where an employee retains a right to reemployment generally do not constitute a separation from service;[10]
- services at a level of 20% or less, compared to the prior 36-month period, for an employee are presumed to mean an employee has separated from service;[11] and
- an employee's continued receipt of salary or participation in employee benefit programs during the absence should be taken into account and may be interpreted as meaning an employee has not experienced a separation from service.

Accordingly, when companies are considering whether their furloughed employees may be deemed to have separated from service meaning that they would be permitted to take distributions from their NQDC plan account balances, they should generally assume that a furlough will not constitute a separation from service unless the circumstances present a more colorable argument that a separation from service has in fact occurred, such as an indefinite furlough where an employee will only be asked to work on an as needed basis.

Separately, companies should also note that the distribution would need to be paid to the employee at the time that the separation from service is deemed to occur, unless the terms of the plan provide differently, and that the determination of whether a furlough or other leave of absence constitutes a separation from service should be made at the time an employee is furloughed or is placed on leave. In addition, companies should note that the separation from service must already be specified as a permissible payment event under the terms of the plan as originally drafted and, if participants have made specific deferral elections, that the elections do not otherwise provide for payment upon a different event or at a different time.[12]

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[10] Treas. Reg. § 1.409A-1(h)(1)(i).

[11] Treas. Reg. § 1.409A-1(h)(1)(ii).

[12] If a plan does not currently provide for payment upon a separation from service, an amendment to the plan to add it as a payment event would not solve for any near-term distributions, as such amendment would need to comply with the rules for "re-deferral elections," which are described in Question 9 below.

## Canceling or Suspending Deferral Elections

The next three questions address considerations when a company is contemplating allowing employees to cancel or suspend existing deferral elections under a NQDC plan as a result of either an unforeseeable emergency or a hardship distribution.

### 4. May employees cancel deferral elections as a result of the COVID-19 pandemic?

**Probably, yes**. Section 409A provides an exception to the general rule against accelerating payment of nonqualified deferred compensation for the cancellation of deferral elections due to either (i) an unforeseeable emergency or (ii) pursuant to a hardship distribution taken under a tax-qualified plan.[13]

- **Unforeseeable Emergency**. This analysis is the same as described in Question 1 above. Section 409A directs employees to first take into account any additional compensation received as a result of the cessation of deferrals under a NQDC plan before taking a distribution under the plan.
- **Hardship Distributions**. These are determined by reference to the rules applicable to 401(k) and other tax-qualified plans, which provide:
  - the employee must have an "immediate and heavy financial need";
  - the distribution must be "necessary to satisfy the financial need";
  - the determination should be based on the relevant facts and circumstances, "in accordance with nondiscriminatory and objective standards set forth in the plan"; and
  - there may be an immediate and financial need even if it is "reasonably foreseeable or voluntarily incurred by the employee".[14]

  Similar to those cited for unforeseeable emergencies, the 401(k) rules include as examples of hardship distributions the need to prevent foreclosures or evictions and to pay for medical or funeral expenses. In addition, the hardship distribution rules specifically include any expenses and losses, including a loss of income, that are incurred on account of a disaster declared by FEMA.

The hardship distribution requirements are easier to satisfy for many employees who are experiencing financial hardship as a result of the COVID-19 pandemic, particularly since they do not require the employees to consider other sources of income before taking a distribution from their tax-qualified plan. In addition, **FEMA has declared** a nationwide emergency during the pandemic, potentially making hardship distributions under 401(k) plans even more readily available.[15] Companies should note that, if terms of the company 401(k) plan require the cancellation of deferral elections under a NQDC plan before an employee may take a hardship distribution, then both sources of liquidity might be available to the employee.

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[13] Treas. Reg. § 1.409A-3(j)(4)(viii).

[14] Treas. Reg. § 1.401(k)-1(d)(3).

[15] We also note that the CARES Act has eased distribution requirements under 401(k) plans, including by permitting "coronavirus-related distributions" of up to $100,000 to employees personally and adversely affected by the COVID-19 pandemic and by providing loan relief for certain qualified individuals.

### 5. May current year deferral elections be merely postponed?

**Generally, no**. Subject to the exception below for performance-based compensation, under Section 409A, deferral elections that are canceled as a result of an unforeseeable emergency or hardship distribution generally must be canceled entirely, and "not merely postponed or otherwise delayed".[16] If an employee cancels a deferral election, any attempt to restart that election later in the year would only be effective with respect to compensation earned in future years.

There is an exception for performance-based compensation that allows employees to make deferral elections up until the date that is six months before the end of the applicable performance period, as long as the amount of the performance-based compensation is not readily ascertainable.[17]

- Example: Consider a company that maintains a NQDC plan under which annual incentive compensation may be deferred. The company's annual incentive compensation program has a performance period of January 1, 2020 to December 31, 2020 and performance for the plan year is measured in early 2021. Under this arrangement, employees could continue to make deferral elections with respect to their annual incentive compensation for the 2020 plan year until June 30, 2020.[18]

### 6. Are there other considerations for companies if an employee elects to cancel a deferral election on account of an unforeseeable emergency or hardship distribution?

**Yes**. Companies should keep in mind the following additional considerations if an employee seeks to cancel a deferral election on account of an unforeseeable emergency or hardship distribution:

- **Review plan documents before any cancellation is effective**. Companies should review the terms of their NQDC plan documents to confirm whether they provide for cancellations upon an unforeseeable emergency or hardship distribution. If the plan does not currently provide for these cancellation events, then the plan will need to be amended, which may be done at any time, before any cancellations become effective.[19]
- **Companies may exercise discretion**. Even if an employee satisfies Section 409A's requirements for canceling deferral elections on account of an unforeseeable emergency or hardship distribution as described above, Section 409A allows companies to exercise discretion on whether or not to permit the cancellation. Some companies may consider other ways of providing relief to their employees.

## Other Possibilities

Given Section 409A's limitations for taking a distribution or canceling a deferral election due to an unforeseeable emergency or hardship distribution, there are other ways that companies may wish to consider permitting accelerations of nonqualified deferred compensation that are compliant with Section 409A. Conversely, it may be the case that, depending on an employee's individual financial

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[16] Treas. Reg. § 1.409A-3(j)(4)(viii).

[17] Treas. Reg. § 1.409A-2(a)(8).

[18] Companies may want to take extra care in reminding their employees about the timing for deferring performance-based compensation, particularly if achievement levels for 2020 incentive compensation are currently in question.

[19] To the extent that a plan provides for employer matching contributions or other employer contributions or benefits, a company will want to consider the impact of a mid-year cancellation on the company's 2020 contributions and benefits.

circumstances, the employee may actually want to further delay upcoming scheduled deferred compensation payments. These alternatives are addressed in the next three questions. For companies that may be contemplating a bankruptcy proceeding, refer to Question 10 below for some additional considerations that may arise in the bankruptcy and pre-bankruptcy contexts.

### 7. May NQDC plans provide for cashouts of deferred compensation?

**Yes**. Section 409A provides an exception to the prohibition on accelerating the payment of nonqualified deferred compensation for limited cashouts of lump sum deferred compensation payments, provided that:

- the plan provision is "executed and effective . . . no later than the date of such payment";
- the "entirety of the service provider's interest" under the plan and any plans that are aggregated with the plan are terminated;[20] and
- the amount of the payment does not exceed specified IRS limits ($19,500 for 2020).[21]

This alternative may be attractive for companies with a broad base of employees that participate in its NQDC plans, who have relatively small account balances, as it allows companies to exercise discretion to cash out employees' account balances at any time and on an individual-by-individual basis. This may also be appealing to employees who do not have significant account balances under the NQDC plan and have a more pressing need for liquidity in the short term. Accordingly, a company could decide to provide cashouts for certain employees, but would not need to do so for other employees who do not have an urgent financial need or who have larger account balances.

### 8. May companies terminate and liquidate NQDC plans?

**Yes**. Section 409A also permits the liquidation and distribution of plan benefits for all employees participating in such plan if the plan is terminated and the following requirements are met:[22]

- the termination does not occur "proximate to a downturn in the company's financial health";[23]
- all plans that would be aggregated with the NQDC plan are also terminated and liquidated;
- no payment may be made within 12 months of the date the termination becomes irrevocable other than payment due at an earlier date in the ordinary course under the normal terms of the plan, such as in connection with a retirement or other interim separation from service;
- all payments must be made within 24 months of the date the termination becomes irrevocable; and

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[20] Under Section 409A's plan aggregation rules, all agreements, methods, programs or arrangements that provide for the payment of nonqualified deferred compensation of the same category are considered to be a single, aggregated plan. There are nine different categories within which a NQDC plan may fall, and a plan may sometimes fall in one or more categories, so companies will want to review these arrangements carefully to determine which plans would need to be aggregated for these purposes. Amounts that are not subject to Section 409A, such as restricted stock units that qualify as short-term deferral arrangements, are not subject to plan aggregation (but note that if a restricted stock unit is structured such that it is not short-term deferral, then the award will be subject to the aggregation rules). Treas. Reg. § 1.409A-1(c)(2).

[21] Treas. Reg. § 1.409A-3(j)(4)(v).

[22] These plan termination rules are separate from the rules governing plan terminations in the change in control context.

[23] Section 409A is not explicit as to the level of financial health that a company must be in to be able to effect a plan termination. Many practitioners take the view, however, that a general downturn in the economy or decline of the company's stock price is not sufficient to preempt the availability of this exception, but rather that the company itself needs to be in severe financial distress for the exception to become unavailable (refer to Question 10 below for special considerations that arise in the bankruptcy context).

- no new plan that would be aggregated with the terminated plan may be adopted at any time within three years following the date the termination becomes irrevocable.[24]

This alternative may be attractive for companies that maintain a NQDC plan where there is relatively limited participation and all employees want to liquidate their account balances. Given the complexities associated with the plan aggregation rules, however, care should be taken to appropriately determine which other plans will also need to be terminated and liquidated so as not to risk a Section 409A violation.

Public companies that have senior executives participating in their NQDC plans should be mindful of the following considerations:

- **Proxy Statement**. Distributions of plan benefits to the company's named executive officers will need to be disclosed in the following year's proxy statement, quantitatively in the Nonqualified Deferred Compensation Table. In addition, narrative disclosure may be required in the Compensation Discussion and Analysis.
- **Form 8-K**. If the plan termination constitutes a material modification of an agreement or arrangement with the company's CEO, CFO or any named executive officers, then a Form 8-K disclosing the terms of the plan termination and the amounts payable to such executive officer or officers will need to be filed. Not all plan terminations may necessarily constitute such a material modification.
- **Shareholder Reaction**. Plan terminations that are accompanied by large-scale distributions of plan benefits to a company's named executive officers may be viewed unfavorably by shareholders and the proxy advisory firms.

## 9. May employees further defer their deferred compensation payments?

**Yes**. It may be the case that some employees who do not have a present need for an acceleration of deferred compensation will want to delay upcoming deferred compensation payments even further down the road. If, for example, an employee has made deferrals of compensation under a NQDC plan that is notionally invested in publicly traded securities, the employee may not want a distribution that would be based on depressed stock prices and may instead prefer to delay the distribution until the markets have hopefully recovered.

Employees may make these re-deferral elections under Section 409A if such elections are permitted under the terms of the NQDC plan and the following conditions are met:

- the re-deferral election does not become effective for at least 12 months;
- payment of the re-deferred compensation may not be made for at least "five years from the date such payment would otherwise have been paid";[25] and
- the re-deferral election must be made at least "12 months before the date the payment is scheduled to be paid."[26]

Given the required delay in both the effectiveness of the re-deferral election and the payment of the re-deferred compensation, employees will want to consider whether their individual financial circumstances and the current market volatility will warrant making these elections. In addition, as noted below, NQDC

[24] Treas. Reg. § 1.409A-3(i)(4)(ix)(C).

[25] Note that this requirement does not apply to a re-deferral election related to payment on account of an unforeseeable emergency.

[26] Treas. Reg. § 1.409A-2(b)(1).

plan account balances are general unsecured claims against a company, meaning that if a company were to enter bankruptcy, the employee may lose their entire account balance.

## Considerations for Companies Contemplating a Bankruptcy

Some companies' business operations have been hit particularly hard by the COVID-19 pandemic, and they may now find themselves in financial distress or in the position of contemplating a bankruptcy proceeding. If limited cash flow is of particular concern, companies may not be in a position to realistically make NQDC plan distributions,[27] and if a bankruptcy becomes a realistic possibility, these options may no longer be available. This last question addresses some of the potential implications that a bankruptcy may have on a company's NQDC plan.

### 10. Are there any special considerations for companies approaching bankruptcy?

**Yes**. For companies that are currently contemplating, or may be soon approaching, a bankruptcy proceeding, the following are a few general considerations to keep in mind:

- **NQDC Plan Accounts Are Not Necessarily Protected in Bankruptcy**. NQDC plan obligations for the account of a company's employees are generally unfunded, unsecured obligations of the company that are subject to the claims of the company's general creditors in bankruptcy. Any assets set aside in a "rabbi trust" to fund these obligations similarly would be subject to the claims of general creditors in the event of a bankruptcy filing. Therefore, employees may receive only a small portion, or none, of their NQDC plan account balance.
  - While NQDC plan obligations that exist prior to the company's filing of a bankruptcy petition may only be preserved for the benefit of the employees if approved by the bankruptcy court, amounts that arise post-petition might benefit from an administrative expense preference.
  - If a NQDC plan is terminated during the bankruptcy proceeding, employees seeking distributions of their plan accounts will be in the same position to receive such funds as any other unsecured creditors of the company.
- **Ceasing Deferral Elections**. Given the abovementioned risk of employees not receiving their nonqualified deferred compensation payments as a result of their company's bankruptcy, companies may wish to consider whether it would be advisable to cease employee deferral elections once a bankruptcy proceeding is on the horizon.
- **Deferring Scheduled Payments**. If making a payment under the terms of a NQDC plan would jeopardize the company's ability to "continue as a going concern" (e.g., if the company is in severe financial distress), then the company could consider whether to delay the payment until the first taxable year after the concern has subsided.[28] Such a decision on the company's part will not violate Section 409A.
- **Potential Clawback of Accelerated Distributions**. If a company accelerates payments from a NQDC plan in advance of a bankruptcy proceeding—for example, as a result of a plan

[27] Given that NQDC plans are an unfunded and unsecured obligation of a company, unless a rabbi trust has been established and funded, any distributions under a company's NQDC plans would deplete existing cash reserves.

[28] Treas. Reg. § 1.409A-3(d).

termination and liquidation—there is a risk that the amounts will become "preference" payments under applicable bankruptcy rules, subjecting the amounts to recovery by the bankruptcy estate.[29]

## In Conclusion

When companies are approached by employees seeking to take distributions from or cancel deferral elections under NQDC plans, they will want to think carefully and creatively about how to meet their employees' financial needs without violating the strict limitations imposed by Section 409A. While circumstances resulting from the COVID-19 pandemic may credibly constitute an unforeseeable emergency for employees, companies should carefully consider whether a request for a distribution or cancellation is a viable option under Section 409A's strict regime. In addition, companies should remember that if payment on account of an unforeseeable emergency is unavailable, there may still be alternatives outside of the unforeseeable emergency context to provide some relief to employees during these challenging times.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.


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[29] As a general matter, Section 547 of the Bankruptcy Code provides that a bankruptcy estate may recover payment to a company's creditors if the payment was made outside the ordinary course of business and was made:

(i) on account of an antecedent debt owed by the company before the payment was made;
(ii) while the company was insolvent; and
(iii) within 90 days of the company's filing of a bankruptcy petition (or one year in the case of payments to insiders (e.g., executive officers and directors)).