

## CONSIDERATIONS FOR NONQUALIFIED DEFERRED COMPENSATION PLANS AMID THE CURRENT CRISIS

### **OVERVIEW:**

Many employers sponsor non-qualified deferred compensation plans that provide for benefits in excess of those under tax-qualified plans. There are strict requirements in operating these plans and failure to follow these rules may trigger penalties and other tax issues for both the employer sponsor and participant.

### **Did we just inadvertently create a nonqualified plan subject to Section 409A of the Internal Revenue Code?**

Under the current situation, many employers have decided to reduce pay temporarily, accompanied with the promise from the employer to make up for the compensation reduction later. This type agreement might actually be a nonqualified deferred compensation plan subject to all of the 409A requirements—including penalties for noncompliance.

Generally, the factors that could affect this depend on whether the new arrangement is compliant; includes the promise of future payment is subject to a continuous employment; future payment timing; and the employee participates in a deferred compensation plan maintained by the employer. Prior to entering into this agreement, employers should seek assistance to avoid potential problems.

### **Due to the current situation, a nonqualified plan participant wants to cease deferrals—this is permissible, right?**

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 exception to this general rule is the occurrence of an unforeseeable emergency with respect to the employee. An unforeseeable emergency is defined as:

- 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 because of events beyond the control of the employee.

First, the current pandemic may or may not be an unforeseeable emergency for a given employee—as it depends on his/her situation. More importantly, a nonqualified plan sponsor cannot simply adopt the CARES Act tax-qualified rules and assume all of these rules extend to non-qualified plans—including the ability to cease deferrals. What is permissible under the tax-qualified rules as a severe financial hardship does not mean that this extends to the operations of a nonqualified plan.

In addition, a 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. As such, an employee cannot simply cancel deferrals for four months and then restart for the remainder of the year.

### **I want to take my money out now rather than wait.**

The rules of Section 409A are very specific about the timing of payments and there are only very limited exceptions to accelerate away from the originally scheduled payment date under the plan.

April 21, 2020

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As noted above, there are exceptions including the occurrence of an unforeseeable emergency and that such a distribution may not be made to the extent that the emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, including by liquidation of the employee's assets or by cessation of deferrals under the plan. Again, a nonqualified plan sponsor cannot simply adopt the CARES Act tax-qualified rules and assume all of these rules extend to non-qualified plans. The participant must have suffered an unforeseeable emergency that would permit early payment of nonqualified deferred compensation

#### **What happens if I separate from service?**

Generally, nonqualified plans provide for payment upon a *separation from service*. Most furloughs, leaves, layoffs, and hour reductions may not qualify as a separation from service.

Under 409A, the employment relationship remains intact:

- If the period while the employee is on sick leave or other bona fide leave of absence does not exceed six months or, if longer, as long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract
- If there is a reasonable expectation that the employee will return to perform service for the employer, after the leave

As such, a separation from service has occurred tied to the facts and circumstances and must indicate that the employer and employee anticipate that no further services would be performed. The rules further provide that if the level of services the employee would perform after a specific 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, then a separation has occurred.

Accordingly, a furlough generally would not be considered a separation from service triggering payment under a nonqualified plan. In addition, a 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.

#### **I actually qualify for a payment but wish to defer since my account balance has dropped—can this occur?**

The 409A strict rules prohibit changes in timing of payment, unless 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, an employee who has met the conditions for separation of service cannot further defer payment with the hope of receiving a higher payout based on improved conditions. For a public company, there are additional requirements that include a six-month delay of a payout to certain employees in connection with a separation from service, which may be beneficial to the employee.

#### **Can an employer delay making payments to an otherwise eligible participant?**

If an employee is ineligible to elect to defer payments and the payment is scheduled to be made now or within the current year, can an employer delay since they have alternate uses for the capital? The 409A rules do provide some flexibility in this situation, if making of a payment at the required date would jeopardize the ability of the employer to continue as a going concern. Under this circumstance, the employer can delay the payment as long as the payment is made during the first taxable year of the employee in which making the payment will not have such effect.

Considering employment contracts and other governing documents should take place to avoid any unintended consequences.



Elliot N. Dinkin  
President/CEO  
elliotd@cowdenassociates.com  
412.394.9997  
[cowdenassociates.com](http://cowdenassociates.com)

