COVID-19: OPTIONS FOR NONQUALIFIED PLANS

These are strange and challenging times. Understandably, plan sponsors and participants of nonqualified plans may be concerned about cash flow and wondering if they have any options for relief under their nonqualified plan. Although recent legislation added additional flexibility for qualified plan participants and plan sponsors during this crisis, similar favorable treatment was not outlined for nonqualified plans. So, what can participants and plan sponsors do? Below are frequently asked questions that address issues resulting from the COVID-19 crisis. These answers utilize existing regulations to assist participants and plan sponsors during this trying time. Please do not hesitate to contact your Client Relationship Manager to discuss a particular scenario in more detail. Please be advised that the information contained herein is not intended as legal advice and should not be relied upon without further consultation with an attorney.

CAN A PARTICIPANT CANCEL NONQUALIFIED PLAN DEFERRAL ELECTIONS IN 2020 DUE TO COVID-19?

Maybe. Unfortunately, there has not been any legislative relief for cancelling deferrals due to the COVID-19 crisis; however, Internal Revenue Code Section 409A (“409A”) allows a participant to cancel deferrals for an unforeseeable emergency.

An unforeseeable emergency under 409A refers to any of the following circumstances:

- a severe financial hardship to a participant resulting from an illness or accident of the participant, the participant’s spouse, the participant’s beneficiary, or the participant’s dependents
- loss of the participant’s property due to casualty
- other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant

Whether a participant has experienced an unforeseeable emergency under 409A depends on the specific facts and circumstances for that individual. Not all hardships created by the COVID-19 crisis will necessarily rise to this level. Plan sponsors with unforeseeable emergency provisions in their nonqualified plans should establish a reasonable, documented administrative procedure to determine unforeseeable emergencies based on any specific set of facts. If a nonqualified plan does not include an unforeseeable emergency provision, it may be added to the plan at any time.

Deferrals cancelled under the unforeseeable emergency exception must be cancelled for the remainder of the calendar year. Participants are not allowed to modify (reduce) the deferral amount. Also, a participant cannot begin deferring again until the 2021 calendar year.

CAN A PLAN SPONSOR DELAY DISTRIBUTIONS TO PARTICIPANTS THAT ARE DUE NOW?

Maybe. Payments are 409A-compliant only if made by the later of the end of the calendar year of the payment date or the 15th day of the third month following the payment date. If the plan specifies a payment date, payment may be made up to 30 days before the trigger date.

A plan sponsor may delay a payment because of certain business concerns. The 409A rule requires that the business concern (such as cash-flow issues) and the time for the later payment be determined by a pre-specified, objective, nondiscretionary formula related to the plan sponsor's business performance. For example, the formula may call for payments in any given year to be limited to a certain percentage of cash flow. A delay is also permitted if the scheduled payment would jeopardize the ability of the plan sponsor to continue as a going concern. Under these circumstances, the plan will remain in 409A compliance as long as the payment is made in the first year in which the concern is eliminated. In addition, if failure to pay is due to the plan sponsor's refusal to pay or its inadvertent delay, there can be no collusion between the participant and the plan sponsor. In these types of situations, the participant must timely notify the plan sponsor that the benefit is due and unpaid; the 409A rules prescribe the details of such notice.

Practitioners caution that the 409A "going concern" exception is a very high bar to meet and little guidance is available from the IRS regarding the circumstances when this exception is available.

CAN CHANGES BE MADE TO PERFORMANCE CRITERIA FOR PERFORMANCE-BASED COMPENSATION DEFERRALS?

Not likely. Some plans allow participants to elect to defer compensation in compliance with performance-based compensation deferral rules under 409A. 409A permits those deferral elections to be made up to 6 months before the end of the performance period for compensation that qualifies as "performance-based compensation" under 409A. To be "performance-based compensation" under 409A, the relevant performance goals must be established no later than the first 90 days of the performance period. For plans that permit deferral elections under this "performance-based compensation" rule, a change to the performance goals after March 2020 may mean the deferral elections cannot be made during the performance year under the performance-based election rules (i.e., deferral elections will only be effective if made before the beginning of the calendar year).

WILL A LAYOFF OR FURLOUGH REQUIRE DISTRIBUTION UNDER THE PLAN?

Maybe. Plan sponsors should critically analyze the type of leave a participant has taken. Questions to consider are:

- Has the employer furloughed the employee (i.e., given a leave of absence)?
- Has the employee terminated employment such that he or she may file for unemployment benefits?
- Is there an intent the employee will be reemployed by the plan sponsor within 6 months?

The employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence **if the period of such leave does not exceed 6 months, or if longer, so long as the individual retains a right to reemployment with the employer under an applicable statute or by contract.**

A leave of absence/furlough constitutes a bona fide leave of absence only if there is a reasonable expectation that the employee will return to perform services for the employer. If the period of leave exceeds 6 months and the individual does not retain a right to reemployment under an applicable statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such 6 month period. There could be contractual rights to reemployment, however, such as under an employment agreement or collective bargaining agreement; in that case, separation from service would occur when the contractual right to reemployment expires.

During a leave of absence/furlough, employees are no longer on payroll but are still considered employed. They are not considered terminated and would not be considered as having a separation from service. It is the employer's decision whether or not to allow continued accrual of vesting, plan participation and/or service during the leave of absence; but for ease of plan administration, it may be best to let those continue. The plan terms may dictate this course of action as well.

If the employer is terminating the employees' service, such that they may file an unemployment claim for benefits, it is up to the plan sponsor to rebut the presumption that the employees have had a separation from service pursuant to 409A. Keep in mind that determining whether a separation from service has occurred includes analyzing the intent of the parties at the time of the separation. If the employer deems a separation from service has occurred and the plan contains separation as a payment trigger, then payments are due and the employee may rejoin the plan once rehired, at the discretion of the employer and in accordance with the eligibility rules of the plan. If there is a reasonable expectation at the time of separation from service that the employee will return, it is likely that a separation from service will not be deemed to have occurred. Furthermore, if a participant is still providing services but at a reduced level, the plan sponsor will need to determine if the reduction in hours amounts to a separation from service. How does the plan define "separation from service"? If a separation is deemed to have occurred, and separation is a trigger in the plan, then payments are due.

CAN A PLAN SPONSOR VOLUNTARILY TERMINATE A NONQUALIFIED PLAN AND DISTRIBUTE BALANCES TO PARTICIPANTS?

Yes, But. 409A allows a plan sponsor to terminate and liquidate a nonqualified plan and distribute vested balances in limited circumstances, one being a discretionary plan termination; however, certain conditions must be met to qualify for voluntary termination of the plan:

- The nonqualified plan, and all similar plans, must be terminated for all participants, not just those who request a payment.
- A voluntary plan termination cannot occur near a financial downturn of the company.
- Payments from the plan may not be made for 12 months after the plan termination date.
- The plan sponsor cannot offer a new nonqualified plan **of the same kind** for 3 years after the action to terminate the plan(s).

CAN A PLAN SPONSOR TERMINATE A NONQUALIFIED PLAN DUE TO BANKRUPTCY?

Yes. 409A allows a plan sponsor to terminate and liquidate a nonqualified plan in connection with a corporate dissolution under IRC Section 331, or with approval of a bankruptcy court under federal bankruptcy laws. The plan sponsor may irrevocably terminate the plan within 12 months of the corporate dissolution or bankruptcy court approval. Payment is made and taxed to the participants no later than the latest of (a) the calendar year of plan termination, (b) the first calendar year in which the amounts are no longer subject to a substantial risk of forfeiture (i.e., vesting), or (c) the first calendar year in which the payment is administratively practical.

CAN A PARTICIPANT'S SMALL ACCOUNT BALANCE BE CASHED OUT?

Yes. Although 409A generally prohibits the acceleration of payment from a nonqualified plan, there is an exception to this general rule for cashing out small benefits. The plan may require (or can give the plan sponsor discretion to require) a mandatory lump sum payout of a participant's benefit if the participant's account balance does not exceed the IRC Section 402(g) deferral limits ($19,500 for 2020). This lump sum payment must result, however, in the termination and liquidation of the participant's entire interest in the plan. If a plan does not contain a minimum cashout provision, the plan can be amended to include the provision provided that the amendment is executed prior to the exercise of the lump sum payout. It is important to keep in mind that plan aggregation rules will apply, therefore a plan sponsor will not be able to use this exception to cash out a participant's benefit under one nonqualified plan but not another nonqualified plan when the two arrangements are treated as a single plan under 409A.

IS IT TOO LATE FOR A PLAN SPONSOR TO PAY A MISSED SHORT-TERM DEFERRAL PAYMENT?

Yes, Unless. For any plan sponsor who has a program that should have met the March 15, 2020 short-term deferral deadline (i.e., has participants who were vested as of the end of 2019), the plan sponsor should consult with its legal counsel to review such program to make sure it is covered by a compliant 409A document so that even if the payment date was missed, the payment does not violate 409A. Generally speaking, a missed short-term deferral payment will be compliant with 409A if paid by the end of this calendar year.

The Pangburn Group is keeping an eye on legal and legislative developments for nonqualified plan sponsors and participants during this COVID-19 crisis and will update our clients as the need arises. Contact a member of our team if you wish to discuss your plan.