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Dealing with the complexities of the strict non-qualified deferred compensation tax rules under section 409A of the Internal Revenue Code is often challenging for employers and employees in the ordinary course of business, as many issues relate to the timing of deferred compensation payments and prohibitions on accelerating or delaying payments.

During times of financial turmoil and business uncertainty, these challenges become even more acute for cash-strapped companies that may want to further delay payments or make other changes to deferred compensation arrangements. It is also difficult for employees who may want to tap into their deferred compensation accounts earlier than the originally scheduled payment dates.

This article focuses on the key 409A issues that distressed companies and their employees, who may be impacted by their own financial hardship, may face in the wake of an economic downturn and addresses the 409A pitfalls that may arise. This is important in order to avoid adverse tax treatment on employees and for companies to deliver compensation in a tax-efficient manner to its employees.

In certain situations, employers may be concerned about their employees' ability to access their deferred compensation benefits and may want to terminate their deferred compensation arrangements and accelerate payments. Companies that are financially troubled or otherwise potentially headed towards bankruptcy may want to set aside funds to ensure their employees get paid their deferred compensation. Each of these situations involves significant 409A issues that should be closely evaluated.

Actual and perceived abuses by employers and employees relating to the payment timing, form, funding, and termination of deferred compensation plans—especially in the bankruptcy context—fueled the enactment of 409A and its largely inflexible regime. Deferred compensation plans and arrangements that do not comply with 409A trigger punitive tax treatment on the employee, including early income inclusion without regard to the deferral, an additional 20% income tax, and possible penalty interest, as well as tax reporting and withholding obligations on the employer.

Reducing Salary and Other Compensation

Impermissible Deferrals of Salary and Other Compensation

Many companies looking to conserve cash may decide to reduce or cease paying base salaries or other forms of compensation, such as bonuses, for certain employees. If an employer takes such action without providing for a "make-up" type of payment or other replacement payment in the future, no 409A issues should be implicated, although other issues should be reviewed.

However, if an employer provides for a subsequent make-up or other replacement payment in lieu of the foregone salary or other compensation, the potential 409A consequences must be considered. In general, the 409A rules require that an employee's election to defer compensation must occur no later than the Dec. 31 of the calendar year preceding the year in which the employee performs the services giving rise to the compensation—subject to certain limited exceptions, including for fiscal year compensation, initial year of eligibility and performance-based compensation. 26 C.F.R. § 1.409A-2(a).

This means, for example, that salary or other compensation earned in 2020 must have been deferred by an employee no later than Dec. 31, 2019, and could not be deferred in 2020. If an employee has a contractual right to a certain level of salary or other compensation such that the employee's consent is required to reduce or eliminate the salary or other compensation, and if the employer commits to provide a replacement payment in a subsequent tax year, a 409A violation will occur. In such instance, the employee did not make a timely deferral election in accordance with 409A and will be subject to adverse tax consequences.

Inadvertently Creating Deferred Compensation

In many cases, an employee may not have a contractual right to a specified salary level or other compensation that an employer may wish to reduce or eliminate. Similarly, an employee may not have a "good reason" right to terminate employment if the employer reduces salary or compensation levels.

Where employee consent to a salary or compensation reduction is not required, if an employer contractually commits to provide for a future payment in a subsequent tax year in lieu of the salary or other currently paid compensation, such payment will be deferred compensation subject to 409A, unless the payment is made during the "short term deferral period"—generally the end of the 2 ½ month period following the later of the end of the calendar year or the employer's tax year in which amounts are no longer subject to a substantial risk of forfeiture. 26 C.F.R. §§ 1.409A-1(a)(1), 1.409A-1(b)(1), 1.409A-1(b)(4).

If deferred compensation is created with such "replacement" payment, it would need to comply with 409A and be paid solely upon a permissible payment event under 409A, or the "earlier of" or "later of" the designated permissible events. These permissible payment events generally include a fixed date or specified time (e.g., anytime during the first quarter of a calendar year, a specific date, or a 30-day period in a specified month), separation from service, death, disability, change in control, or unforeseeable emergency, and would need to preclude the acceleration of payment or further deferral of payment, except to the limited extent permitted by 409A. 26 C.F.R. § 1.409A-3.

Care should be taken to correctly structure the deferred compensation payment and memorialize the relevant terms in a document containing provisions that comply with 409A, including specifying the form and timing of payment of the deferred compensation.

Permitted Delayed Payments of Deferred Compensation

Going Concern Exception

Distressed companies sometimes face situations where it is impossible or nearly impossible to make payments of non-qualified deferred compensation at the time required by the plan or arrangement. The 409A rules generally prohibit delayed payments or further deferrals of already deferred compensation other than in accordance with the subsequent deferral rules. Under these rules, an employee may elect to change the time or form of a deferred compensation payment only if all of the following conditions are met:

- The plan requires that the subsequent deferral election not take effect until at least 12 months after the date on which the election is made.
- Except with respect to payments made on account of disability, death or an unforeseeable emergency, the plan requires that the subsequent deferral be made for a period of not less than five years from the date payment would have otherwise been made.
- The plan requires that any election related to payment at a specified time or pursuant to a fixed schedule be made no less than 12 months before the date the payment is scheduled to be paid.

26 C.F.R. § 1.409A-2(b)(1).

However, 409A allows an employer to delay the payment of deferred compensation where timely payment would jeopardize the ability of the employer to continue as a "going concern." The payment will be treated as made upon a date specified under the plan if the payment is made during the first taxable year in which the making of the payment would not have such effect. 26 C.F.R. § 1.409A-3(d).

The burden of proof rests on the employer to demonstrate that the payment meets the going concern standard. There is scant guidance on what constitutes jeopardizing an employer's ability to continue as a going concern, although the preamble to the final regulations suggests that any determination would be based on the applicable facts and circumstances which might include the violation of a loan covenant. Preamble to Final 409A Treasury Regulations, Section VIII(I). Notably, the final 409A regulations relaxed the prior requirement that the payment would have had to jeopardize the solvency of the employer. Preamble to Final 409A Treasury Regulations, Section III(C)(1).

Legally Required Delay

An employer may delay the payment of deferred compensation where the payment would violate applicable law. 26 C.F.R. § 1.409A-2(b)(7)(ii). In the context of a bankruptcy, where the bankruptcy court has ruled that a payment may not be made, the payment may be delayed without a 409A violation.

An Opportunity to Delay Payment

Depending upon the contractual language of a non-qualified deferred compensation plan or arrangement, any employer, including one that is fiscally challenged, may be able to somewhat delay the payment of the deferred compensation without running afoul of 409A. Under the final regulations, a payment is treated as made upon a designated payment date in accordance with 409A if the payment is made on such date or a later date within the same taxable year or, if later, by the 15th day of the third calendar month following the date specified in the plan and the employee is not permitted, directly or indirectly, to designate the tax year of payment. 26 C.F.R. § 1.409A-3(d).

If the employer is not limited under the terms of the deferred compensation plan or arrangement as to the specific time of payment of the deferred compensation, this rule may provide the employer with some flexibility to delay payment. This may be particularly helpful for employers with cash flow timing issues.

Permitted Accelerated Payments of Deferred Compensation

Plan Terminations

Prior to the enactment of 409A, employers were free to terminate any or all non-qualified deferred compensation plans and arrangements at any time without restriction and accelerate the distribution of the deferred compensation to participants. Although 409A generally prohibits the acceleration of deferred compensation payments, accelerated payments are permitted upon certain terminations specifically enumerated in the final regulations, subject to satisfying conditions set forth in the regulations.

Putting aside plan terminations in the context of a change in control or ownership of a company, a plan may provide for accelerated payment in connection with a plan termination and liquidation occurring within 12 months of a corporate dissolution taxed under section 331 or with the approval of the bankruptcy court pursuant to 11 U.S.C. § 503(b)(1)(A), subject to certain conditions relating to the timing of inclusion of the deferred amounts in participants' gross incomes. 26 C.F.R. § 1.409A-3(j)(ix)(A).

Alternatively, a company may accelerate deferred compensation payments in connection with a plan termination and liquidation that meets all of the following conditions set forth in the final regulations:

- The termination and liquidation does not occur proximate to a downturn in the financial health of the employer.
- All related non-qualified deferred compensation plan that are required to be aggregated with the plan being terminated and liquidated must also be terminated.
- No payouts may occur within 12 months of the board action to irrevocably terminate the plan.
- All payments must be made within 24 months following approval by the board of the plan termination.
- The employer must not adopt a new similar type of deferred compensation plan in the three years following the date the employer first took irrevocable board action needed to terminate the deferred compensation plan.

26 C.F.R. § 1.409A-3(j)(ix)(C).

Although this type of termination gives some flexibility to employers to terminate their deferred compensation plans and distribute funds to participants, it is difficult for financially troubled companies to implement this type of termination due to the prohibition that the termination not occur proximate to a downturn in the financial health of the employer.

There is no guidance as to what this prohibition means, although the facts and circumstances surrounding a company's financial situation should be considered. Many practitioners take the view that a general decline in the economy is not sufficient to trigger the prohibition, but that the employer must be in financial distress itself for the prohibition to apply.

Once the downturn has occurred and the employer has filed for bankruptcy, the employer may be able to terminate the plan, presumably, with bankruptcy court approval, by using this rule. Although distributions would be allowed under 409A at that time, from a practical perspective, the full deferred compensation benefit may not be available for distribution as participants are likely to be unsecured general creditors of the company without other funding protection.

Unforeseeable Emergency Distributions

An unforeseeable emergency is a permitted payment event under 409A which may be incorporated into a deferred compensation plan at the time of adoption or added at a later point to a plan to allow accelerated payments of previously deferred amounts without violating 409A. 26 C.F.R. §§ 1.409A-3(a)(6) and 1.409A-3(i)(3). Plan participants affected by the global Covid-19 pandemic or with other economic troubles may wish to seek an early payment of deferred compensation, but hardship distributions for an unforeseeable emergency may only occur if specific requirements are met. Unforeseeable emergencies include the following:

- An illness or accident of the employee or the employee's spouse or dependents
- Property loss caused by casualty
- Funeral expenses of the employee or the employee's spouse or dependents
- Other similar extraordinary and unforeseeable circumstances resulting from events beyond the control of the employee or the employee's beneficiary

26 C.F.R. § 1.409A-3(i)(3)(i). The participant seeking the distribution must demonstrate that the unforeseeable emergency could not otherwise be eliminated by insurance, liquidation of the participant's assets—to the extent the liquidation would not create severe financial hardship— or cessation of deferred compensation plan deferrals. The amount of the distribution must be limited to the amount needed to satisfy the unforeseeable emergency, plus applicable taxes.

Because many deferred compensation plans tend to cover the more senior executives in a company, using the unforeseeable emergency trigger to accelerate the payment of deferred compensation is sometimes impractical due to the strict requirements that apply to these distributions.

Cancelling Deferral Elections

Employees who participate in a voluntary deferred compensation plan may wish to cease their deferral elections if their employer is in financial distress or if they want immediate access to the funds they would otherwise contribute into the deferred compensation plan. In general, participants cannot change their deferral election mid-year; rather, deferral elections must generally be made by the Dec. 31 preceding the year in which the compensation is earned and cannot be changed.

However, a deferred compensation plan may allow an employee to cancel a deferral election if the employee receives a hardship distribution under the employer's 401(k) plan (or other eligible retirement plan). 26 C.F.R. § 1.409A-3(j)(4)(viii). Recently, the Internal Revenue Service clarified in Notice 2020-50 that a participant who elects and receives a 401(k) withdrawal that constitutes a "coronavirus-related distribution" under the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Pub. L. 116-36) will be considered to have received a hardship distribution for purposes of 409A. In such case, the employee may cancel a deferred compensation deferral election at that time without violating 409A.

Funding Deferred Compensation Plans

Employers, even those that are experiencing financial challenges, may seek to provide additional comfort and certainty to employees by funding deferred compensation plans through rabbi trusts. A rabbi trust is a grantor trust that may be used by a company to set aside funds to pay its employees' deferred compensation obligations without resulting in immediate taxation to the participants, provided that funded amounts remain subject to the claims of the company's general unsecured creditors.

A public company that sponsors a deferred compensation plan while it or any member of such company's controlled group also sponsors a single employer defined benefit pension plan could be restricted when funding its deferred compensation plan. A company with a defined benefit plan in its controlled group may not set aside, reserve, or transfer monies into a rabbi trust or other funding arrangement to pay deferred compensation payments to certain applicable "covered employees,"—i.e., covered employees under I.R.C. § 162(m)(3) and employees subject to Section 16 of the Securities Exchange Act of 1934), during a restricted period. I.R.C. § 409A(b)(3). A restricted period is any of the following periods:

- Any period when the defined benefit plan is in "at-risk" status (as defined under I.R.C. § 430(i))
- Any period when an employer is a debtor in a Chapter 11 bankruptcy
- Any 12-month period that begins six months before the termination of the defined benefit pension plan if that plan is not adequately funded for its liabilities upon plan termination

If amounts are funded into a rabbi trust to pay such applicable covered employees during a restricted period, a 409A violation will occur and such amounts that are funded will become immediately taxable to the applicable covered employees and subject to a 20% additional tax and penalties.

During these uncertain times, companies may elect to establish a rabbi trust, insure the benefits, have an affiliate guarantee the payments—subject to the affiliate's creditors—or somehow otherwise segregate funds for purposes of paying liabilities related to deferred compensation plans, but should consider whether there are restrictions applicable to funding those benefits. Although not a 409A issue, companies, especially distressed companies, must be mindful that the assets set aside in a rabbi trust are subject to the risk of the company's general unsecured creditors.

Conclusion

Employers and employees who experience financial distress often want to make changes to their deferred compensation plans and arrangements, triggering various potential 409A issues. In some cases, employees may want to access these funds earlier than originally scheduled for a whole host of reasons, including credit risk of the company and personal financial hardship.

At the same time, employers may wish to further delay payments, conserve cash, and make future payment commitments, or perhaps fund their deferred compensation obligations through a rabbi trust to provide psychic comfort to their employees. In these and other situations, employers and employees, with the advice of counsel, should carefully evaluate the 409A considerations in order to avoid potential pitfalls and deliver tax-efficient deferred compensation.

