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Executive Compensation

Executive Compensation Issues Emerging from the COVID-19 Crisis

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As the country's citizens and economy struggle to survive and recover from the COVID-19 crisis's fearsome fallout, the issue of executive compensation is understandably low on, if not completely off, the collective radar. Nevertheless, the topic still must be addressed because with so many employees and their employers placed in such a precarious position by the pandemic, the need for strong executive leadership is crucial. Furthermore, the recent passage of the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) as well as general liquidity and business continuity concerns due to

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the financial crisis have created circumstances calling for reductions in executive compensation. Employers and employees, however, must take care in the manner in which such reductions are implemented in order to remain in compliance with Internal Revenue Code Section 409A. In addition to analyzing these topics, this column also reviews other executive compensation issues that should be examined during these turbulent times.

CERTAIN CARES ACT PROVISIONS REQUIRE EXECUTIVE COMPENSATION CUTBACKS

A broad-based, $2.3-plus trillion stimulus package, the CARES Act provides relief assistance to employers and employees suffering financial losses due to the effects of COVID-19. There are two specific sections of the CARES Act that impose restrictions on the executive compensation paid by businesses that receive loans, loan assistance, or other financial assistance under Title IV of the CARES Act (*i.e.*, the section that provides $500 billion to the U.S. Treasury's Exchange Stabilization Fund; however, employers that seek relief under the Paycheck Protection Program established by Title I of the CARES Act are not subject to the above-referenced limits):

Loans for Eligible Businesses

The general rule is that an employer receiving one of these loans (*i.e.*, Exchange Stabilization Fund Loans under Section 4003 of the CARES Act) must limit the "total compensation" of its "covered employees" during the "restricted period," with such terms being defined as follows:

- "Total compensation" means salary, bonuses, stock awards, and other financial benefits (note, however, that additional guidance is needed regarding how equity awards and other noncash benefits will be valued for this purpose).[1]

- "Covered employee" means any employee or officer who received total compensation in 2019 greater than $425,000.[2] (Note that unless guidance to the contrary is issued, employers may wish to adopt the following conservative approach for any covered employees who were hired at some point in 2019 and thus did not complete a full year of employment: annualize such employee's 2019 pay in order to determine if the $425,000 threshold applies).

- "Restricted period" means the period beginning on the date the loan or guarantee agreement is entered into and ending one year after the loan or guarantee is no longer outstanding.[3]

If a business that receives a loan has any covered employees, such employees' compensation must be limited as follows:

- Total compensation cannot exceed such calendar-year 2019 total compensation over any consecutive 12 months of the restricted period; or

- Severance benefits cannot exceed more than two times such calendar-year 2019 total compensation.[4]

In addition, if any officer or employee of the business had total compensation that exceeded $3 million in calendar-year 2019, then during any consecutive 12 months of the restricted period, such employee or officer may not receive total compensation that exceeds the sum of:

- $3 million, plus

- 50 percent of the excess over $3 million of the total compensation received by the officer or employee in calendar year 2019.[5]

Specific Rule for Air Carriers or Contractors

Air carriers or contractors receiving other financial relief under Section 4116 of the CARES Act (*i.e.*, the "air carrier worker support" provisions) are subject to the broader eligible-business compensation limit described above; however, for covered employees of these entities, the restricted period is the two-year period spanning from March 24, 2020, to March 24, 2022.[6]

LOAN RECIPIENTS FACE MANY OUTSTANDING CARES ACT COMPENSATION LIMIT QUESTIONS

As typically occurs with any broad-based legislation (and particularly that which is rushed to enactment during times of emergency), there often is the need for additional guidance in order to discern how its rules/restrictions should be applied and how taxpayers should comply with such rules/restrictions. The CARES Act is no different, as businesses that seek the loan relief will need to address the following open questions as they attempt to apply the compensation limits to their covered employees:

- Do companies have to place any restrictions on executives hired on or after January 1, 2020, and, if yes, how should the limits apply to them?
- What are the specific types of compensation that businesses must count when determining what constitutes severance pay?
- If the covered employee is entitled to any equity acceleration, should the value of such acceleration be included in calculating total compensation or severance pay?
- If the value of such acceleration must be included, how shall it be determined?
- What about any qualified plan and/or nonqualified deferred compensation plan benefits contributed on behalf of or distributed to the covered employee? Should such amounts be counted? If yes, when?
- A common feature in executive employment contracts and other executive compensation agreements is a provision that entitles the executive to certain benefits upon his or her voluntarily resigning from the company for "good reason." Under these terms, "good reason" is generally defined as the company changing the individual's working conditions and/or terms of employment to such an extent that it constitutes a good reason for the executive to resign and receive severance. One of the most common of these good-reason triggers is a substantial reduction in pay. Accordingly, there is a concern as to whether imposition of the CARES Act compensation limits may permit executives to terminate for a good reason, thereby entitling them to whatever benefits such a termination would trigger under their existing employment arrangements.
- Once the restricted period has expired, will the company be permitted to restore the payments that the executive was prohibited from receiving during such period (*i.e.*, are the

payments curtailed during the restricted period permanently forfeited or merely suspended)? If yes, and such is characterized as a deferral of compensation, will a special exemption from Code Section 409A be granted? (Note: absent any statutory relief issued in conjunction with future guidance, there may be significant 409A consequences resulting from how business's handle the compensation issues created by not only the CARES Act but also, as described in the next section, the business and economic hardships stemming from the COVID-19 crisis).

Hopefully, these questions will be addressed sooner than later by additional guidance from the Treasury Department. Until then, before a company makes its final decision on whether to participate in the CARES Act loan program, it will need to consult its corporate legal counsel to assist in establishing a good-faith process for identifying covered employees and, if needed, modifying existing compensation arrangements to ensure that the compensation limits are not exceeded. Once the decision is made and a loan is accessed, the company must then implement procedures to track and limit its covered employees' compensation, a task that may prove difficult since the rules require the limit be applied on a rolling 12-month basis.

COVID-19 CRISIS CAUSES COMPANIES TO CONSIDER EXECUTIVE COMPENSATION CUTBACKS

While the previous section examined cutbacks required by employers participating in the CARES Act loan program, these are not the only employers for which such reductions are being considered. The severe economic downturn caused by the COVID-19 crisis has led many businesses to at least explore the option of reducing or delaying the amount currently scheduled to be paid to executives, whether it be through:

- Straight salary or other compensation reductions;
- Ad hoc salary deferrals by management;
- Delays in bonus payments; or
- Delays in payment deferred compensation.

However, unless guidance is issued granting employers affected by the crisis with a temporary exemption from Code Section 409A compliance, any such actions run the risk of invoking a 409A violation and thereby subjecting the affected covered employee to the resulting adverse tax consequences (*i.e.*, a 20-percent penalty tax and interest in addition to normal income taxes).

The following section reviews the Code Section 409A considerations that must be analyzed before an employer implements any of these executive compensation reduction strategies.

409A CONSIDERATIONS BEFORE EXECUTING MANDATORY EXECUTIVE COMPENSATION CUTBACKS OR DEFERRALS

Decreasing or Deferring Salary or Other Compensation Amounts

If an employer is considering such cutbacks or deferrals, the first decision they must make is whether to implement them as mandatory or as a voluntary measure to be elected by the executives. Unfortunately, the adoption of either option could lead to unintended and undesirable consequences. The ability of an employer to mandatorily make cutbacks or deferrals will generally be governed by its contractual commitments to employees and the facts and circumstances of situation. For example, if an employer has executives whose terms of employment are covered by employment agreements, any attempt to impose mandatory executive compensation cutbacks or deferrals without the consent of the executive could result in a breach of their contractual obligation to such executives. In addition, as previously discussed, if the executives' agreements contain good-reason termination clauses, such unilateral reductions may grant the executives the ability to not only resign but also become entitled to potentially significant payouts upon their termination. Consequently, the employer's effort to save money during this fiscally challenging time would not only result in the loss of a valuable employee but also an additional expenditure that could be in excess of the amount that would have been gained from the cutback.

If the executives in question are "at-will" employees and thereby not subject to such contractual protections, the employer may be able to impose mandatory cutbacks or deferrals. The employer's unilateral imposition of compensation cutbacks or deferrals, however, may create morale problems or resignations of executives at a time when the business most needs these individuals to demonstrate the leadership and management skills for which they were selected to fill their executive positions. Furthermore, if the employer promises to restore this "lost pay" or other compensation in the future, the IRS could very well view such promise as a nonqualified deferred compensation plan (an NDCP) after examining factors such as the timing of any future restoration payments and whether not the promise of such future payments is subject to the executive's continuous employment with the company. Such a finding may be costly if the employer did not intend to establish an NDCP, as such payments would most likely not comply with the various Code Section 409A requirements and thereby result in a 409A violation and the corresponding adverse tax consequences. Accordingly, an employer must analyze if any deferral or the promise with respect to any cutback amount could constitute an NDCP and structure the arrangement so it will not violate Code Section 409A. In the case where an employer cannot impose mandatory cutbacks or deferrals, such employer would need to seek voluntary cutbacks or deferrals. While such voluntary cutbacks or deferrals would not breach contractual provisions, they raise a number of tax issues discussed in more detail below.

Delaying Annual Bonuses

Deferring annual bonuses raises additional issues under Code Section 409A that do not apply to deferral of salary or other compensation discussed above. As with deferral of salary or other compensation, whether an employer can mandatorily impose deferrals unilaterally is at first generally governed by its contractual commitments to employees and/or applicable plan documents, as well as the facts and circumstances of the situation. The employer, however, should keep in mind that the ability for executives to voluntarily elect to defer an annual bonus is very limited, as such may run afoul of the Code Section 409A deferral election rules discussed below.

Companies with a calendar year fiscal year typically pay their annual bonuses during the first quarter of the following year. If such bonuses are not subject to a substantial risk of forfeiture in the year in which they are paid (*i.e.*, the employees became vested in them in the prior year and thus will be entitled to payment in the current year regardless of whether or not they are employed on the actual payment date), the amounts would have to paid no later than March 15th in order for the bonus plan to qualify for the short-term deferral exception that enables such plans to be exempt from Code Section 409A coverage. In such cases, these bonuses would have most likely already been paid in 2020 before the financial effects of the COVID-19 quarantine were being fully felt. However, if a company was already facing liquidity issues and did miss the March 15th payment date, they will need to address the Code Section 409A issues such missed payment creates and determine what corrective measures may be available.

Other companies, however, maybe in a position where they have not yet paid their 2019 annual bonuses and thus might be considering delaying such payment in order to shift cash payments to other employee priorities and/or conserve cash flow. In order to not run afoul of Code Section 409A, such a bonus plan would have to either be designed to be exempt from 409A or to comply with it. Since the above-described March 15th deadline has already passed, these plans would only satisfy the Code Section 409A short-term deferral exception if (1) they have a fiscal year different from the calendar year or (2) they required executives to remain employed through the specified bonus payment date in 2020 in order for the 2019 bonus to be considered earned and vested (*i.e.*, as opposed to such bonus becoming vested by virtue of remaining employed until the last day of 2019). Under such circumstances, if the company elects to delay payment of the bonus from the 2020 date on which it is typically paid, the company will need to consider:

- If it will require continued employment through the delayed payment date to receive the bonus;

- Whether such requirement is permissible under the Code Section 409a rules; and

- Whether it can be enforced or is practicable under the circumstances.

To the extent a requirement of continued employment is permissible under the Code Section 409A rules will depend upon the plan document and the facts and circumstances. For example, if an employer has agreed in a plan document to pay an annual bonus for 2019 by March 15, 2020, and such employer later entered in an agreement to defer the payment of the bonus to a later date, subject to continued employment through the date of payment, such extension would generally be a violation of the Code Section 409A rules, as the extension of the period during which a bonus or other compensation is subject to a substantial risk of forfeiture will generally be disregarded in determining whether compensation is subject to a substantial risk of forfeiture.[7] However, if the plan document provides that the employee must be employed on the payment date without specifying such date, the employer may be able to delay payment subject to continued employment. Whether a delayed payment is enforceable or practicable under the circumstances would depend upon the facts and circumstances, such as what commitment has been made to, and what is the expectation of, employees as to when such bonuses would be paid. In the event the continued employment requirement is not permissible or cannot be enforced and the bonus does vest at the end of the applicable calendar year or fiscal year, as applicable, the payment must be made no later than the end of the short-term deferral period (*i.e.*, March 15 or two-and-one-half months after the end of the company's fiscal year, if later).

In contrast, the bonus plan could have been originally designed to be compliant with as opposed to exempt from Code Section 409A. For example, the plan may have been covered by a written document, as required by Code Section 409A, which specified that the bonus be paid on a permissible payment event under 409A, such as specified date or period (*i.e.*, the first quarter of 2020). In such a case, it may not be possible to delay the payment without complying with the change in time and form of payment rules under Code Section 409A, which generally requires the change be made at least 12 months prior to the scheduled payment date and which change must defer payment for at least five years.[8] The rules of Code Section 409A, however, would allow the employer to delay payment of the bonus until the last day of 2020 without changing the plan.[9] As previously indicated, however, such a delay may present contractual and employee relations issues.

Last but not least, it should be noted that Code Section 409A does generally provide that bonus payments under any of the above-described scenarios may be delayed in cases where the payment would jeopardize the ability of the company to continue as a going concern.[10] This, however, is a strict standard and the burden of proof would rest on the company in the event such position was challenged by an employee or the IRS.

Delaying NDCP Payments

In addition to the cash flow strain of paying executive salaries and annual bonuses during this financial crisis, it is also possible that NDCP distributions may be due because one or more of the NDCP participants experience distribution-triggering events under the plan in 2020. Whether an employer can mandatorily impose deferrals unilaterally will usually be governed by the plan document; however, the ability for executives to voluntarily elect to defer deferred compensation is very limited under most NDCP plan documents, as voluntary deferrals are limited by the Code Section 409A "deferral election" rules discussed below.

As with annual bonuses, NDCPs sometimes are designed to pay amounts within the short-term deferral exception. Delaying the payment date with respect to such plans raises the same issues discussed above for delaying payments for annual bonus plans structured to fall within the short-term deferral exception. As with annual bonus plans, NDCPs are also sometimes designed to be compliant with, as opposed to exempt from, Code Section 409A by stating payment must be made upon on a permissible payment event under 409A, such as a separation from service or specified date or period *(i.e.*, the first quarter of a calendar year). As with annual bonus plan designed to be compliant with Code Section 409A, it may not be possible to delay the payment under such a plan without complying with the change in time and form of payment rules under 409A (which generally requires the change be made at least 12 months prior to the scheduled payment date and which change must defer payment for at least five years).[11] The rules of 409A, however, would allow the employer to delay payment of the bonus until the last day of the calendar year of the payment date or period without changing the plan.[12]

The same "going concern" standard discussed above is available to NDCPs for determining whether a payment can be delayed without violating Code Section 409A. As is the case with the delay of annual bonus payments, such a postponement will require the employer to seek its legal counsel's opinion as to the contractual and 409A obstacles to such a decision.

A common permissible payment event with respect to NDCPs designed to be compliant with Code Section 409A is a "separation from service". In addition to determining what, if any, option there is to delay such payments as discussed above, the employer must first review the plan's terms and the particular participant's situation to ascertain if a true trigger event has occurred. Depending on the terms of the NDCP, furloughs, leaves, layoffs, and hour reductions may not qualify as a separation from service. The Code Section 409A rules treat the employment relationship as remaining intact as long as the employee is on sick leave or other "bona fide leave of absence" (note: a leave of absence will qualify as "a bona fide leave of absence" only if there is a reasonable expectation that the employee will return to perform service for the employer), provided that such period of leave does not exceed the longer of:

- Six months, or
- The period of time such individual retains a right to reemployment with the service recipient under an applicable statute or by contract.[13]

In addition, the determination of whether a separation from service has occurred is based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such 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.[14] These rules are particularly relevant in the current tumultuous employment environment because a furlough may not meet the Code Section 409A separation-from-service standard, triggering payment from an NDCP. Furthermore, it is important for employers to keep the above-referenced "no further services reasonably anticipated" proviso in mind because, even if the participant is technically terminated as opposed to being furloughed, if there is an understanding between the company and the participant that he or she will be rehired, such termination generally would not initially qualify as a true separation from service for purposes of triggering payment from the NDCP. If circumstances change in the future and the employer and employee reasonably anticipate that the employee's services will permanently cease (or be substantially reduced to the above-described level), then a separation from service would be deemed to occur.[15] In such case, however, it is recommended that there be some written evidence documenting a valid business or personal reason for such change in understanding in order to prove that the failure to distribute the NDCP benefit at the initial "termination" was not the product of collusion between the employer and participant in order to bypass the strict Code Section 409A subsequent deferral rules and permit the participant to postpone payment until a future date of his or her choosing.

Another point to consider is the case where a company refuses to pay an amount due under the NDCP without the employee's consent. In such a case, the amount generally will be treated as paid in a timely manner if the NDCP participant makes reasonable, good faith efforts to collect the payment.[16] This provision is intended to address not only intentional refusals to pay but also inadvertent delays (but, in either case, only if there is no collusion between the company and participant). Furthermore, in order to avoid a Code Section 409A violation, if the company fails to make a payment on the required payment date, the participant must make reasonable, good-faith efforts to collect the payment, generally through providing timely notice to the company that the payment is due and unpaid.[17] For this purpose, efforts to collect the payment will be presumed not to be reasonable, good-faith efforts if notice is not given to the company within 90 days of the latest date upon which the payment could have been timely made in accordance with the terms of the plan and the Code Section 409A rules and, if not paid, further measures to enforce the payment are not taken within 180 days after such date.[18] Implementing such a "refusal pay" position will also create a contractual breach and perhaps negative participant morale. The reason "perhaps" is used in the previous sentence is that if the amount to be distributed is coming from a defined contribution (DC) NDCP in which benefits are based on the value of specified market investments (*e.g.*, company stock, mutual funds, stock index), such value may have decreased dramatically in the past few months due to the COVID-19–related extreme market downturn. In the event the executive is not in the financial position of relying on the distribution to meet living expenses, such participant may actually prefer that the payment be delayed to a future date when the market—and thus his or her account balance—recovers from the effects of the pandemic. Consequently, even if delaying distributions is not being considered by the employer, it may receive deferral requests from participants. Employers, however, must refrain from acquiescing to such requests unless the election meets the strict Code Section 409A rules governing subsequent deferral elections (*i.e.*, made at least 12 months prior to the scheduled payment date and must defer payment for at least five years).[19]

In practice, the above-described options for an employer to delay NDCP distribution will only be available to those companies that are utilizing a pay-as-you-go approach or funding their NDCP in a vehicle other than an irrevocable rabbi trust. If the funds to pay the NDCP benefits are invested with a third-party trustee in an irrevocable rabbi trust, such trustees are generally obligated to pay such assets to the participants when due and cannot divert such funds back to the company. Since Code Section 409A's rules are very complex and can trigger significant adverse tax consequences for employers and employees, the companies should seek counsel to assist them in closely examining their situation before making a final decision to delay payment.

409A CONSIDERATIONS BEFORE PERMITTING VOLUNTARY EXECUTIVE COMPENSATION CUTBACKS OR DEFERRALS

In the situation where a company decides to reach out to executives regarding the possibility of them voluntarily electing to eschew or defer a portion of their compensation to assist the business during these tough times, the company needs to consider potential Code Section 409A compliance issues. As discussed above, for annual bonus plans and NDCPs, the company will need to determine the extent the plan document permits voluntary deferrals and/or whether such a document can be amended to permit such deferral. In addition, there are some major tax questions that will need to be addressed before seeking such a voluntary reduction or deferral.

Do Voluntary Deferral or Reductions in Salary or Compensation Result in Constructive Receipt?

The concept of "constructive receipt" states that cash basis taxpayers must include gains, profits, and income in gross income for the taxable year in which they are actually or constructively received.[20] Under this doctrine, income, although not actually in the taxpayer's possession, is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.[21] Income, however, is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[22] Accordingly, a voluntary deferral of compensation that is earned and otherwise available to an employee will not defer imposition of income tax since such employee will be deemed in constructive receipt of such amounts on the original payment date. Thus, the employee would owe tax on the original payment date on amounts that will not be paid until a later date. In addition, constructive receipt might also apply to compensation reductions as granting an executive the ability to voluntarily reduce their pay or other compensation—even if it is in the best interest of the company—and might also be seen as turning their back on compensation that would otherwise be paid to them, particularly for amounts already earned or related to past service.

In general, if a voluntary reduction in salary or compensation relates solely to amounts earned for future service, such would normally not be seen as raising constructive receipt issues. However, even in such a case, from the IRS's standpoint, it may be difficult to imagine such a reduction voluntarily occurring without there being some implicit "quid pro quo" between the company and executives that they would be rewarded for their present sacrifice with some future award. Thus, even if there is no constructive receipt with respect to such a reduction, a question for the employer to consider is whether the IRS will see an implicit "quid pro quo" in a compensation reduction and argue that such is a new deferred compensation arrangement for purposes of Code Section 409A as discussed below.

Do Deferrals or Reductions of Salary and Bonus Create New Deferred Compensation Arrangements under 409A?

A deferral of salary or other compensation by an executive could create a new deferred compensation arrangement that could be subject to Code Section 409A, In addition, as discussed above, reductions in salary or other compensation could very well be viewed as creating a new deferred compensation arrangement if an express or implicit quid pro quo is involved. Accordingly, companies considering such deferrals or reductions should consider whether the arrangement is exempt from, or needs to comply with, Code Section 409A. One issue to consider is whether executives who voluntarily agree to such deferrals or reductions could be seen as making a "deferral election" that needs to comply with Code Section 409A. For companies with ongoing NDCPs, participants are generally required to make any compensation deferral elections prior to January 1 of the calendar year of reference.[23] However, as long as the company in question does not already have any NDCPs already in effect that fall into the Code Section 409A category of an individual account or DC-style plan, the company could establish a new NDCP mid-year and enable their executives to defer as much as 100 percent of their compensation for the remainder of the year. Code Section 409A provides that in the case of the first year in which a participant becomes eligible to participate in the plan, an initial deferral election may be made within 30 days after the date the service provider becomes eligible to participate in the plan, with respect to compensation for services to be performed subsequent to the election.[24] Similarly, if the company already maintained an NDCP but certain executives had not previously been designated as eligible for participation in the plan, the company could designate them as eligible in 2020 and, if the plan so provides (or, if not, the plan could be amended to permit mid-year entry for new participants), then they could be given the opportunity to defer all or a portion of their compensation for the remainder of 2020.[25] Before implementing such a strategy, companies must not only review the related 409A rules to ensure compliance but also be careful that they limit participation in the new or existing NDCP to a group that meets the Top Hat criteria (*i.e.*, these plans must be limited to primarily a select group of highly compensated or top management employees).[26]

409A AND CORPORATE CONSIDERATIONS BEFORE PERMITTING NDCP PARTICIPANTS TO ACCESS FUNDS DURING THE CRISIS

Companies are not alone in feeling the financial burden created by the crisis. Executives may also find themselves in a situation where funds are in short supply—especially if they are subject to the compensation cutbacks or delays in payment. In fact, if the affected executives are participants in an NDCP, the company may wish to alleviate the financial hardship created by such cutbacks or delays by allowing the participants to cancel their existing deferrals and/or receive in-service distributions from the NDCP. However, if the company is in the position of conserving cash flow (*e.g.*, by implementing compensation cutbacks or delays), offering such options to the participants will only be appealing if the NDCP's benefits are payable from an irrevocable rabbi trust. Alternatively, for companies utilizing the pay-as-you-go approach or informally funding the NDCP with assets invested in a separate vehicle under which the assets remain accessible, such companies may be less likely to want to offer these options since they will draw down assets that could be used for other corporate priorities.

Canceling 2020 Current Deferral Elections

The general rule is that once the deadline for making the deferral election under the NDCP plan has expired (*i.e.*, in this case December 31, 2019), the election for the year of reference becomes irrevocable.[27] Any subsequent revocation or cancellation of the election in effect for that year would create Code Section 409A violation and adverse tax consequences. The one exception to this rule is that the deferral election may be canceled in the event that the executive experiences a severe unforeseeable emergency (as defined under Code Section 409A) or takes a hardship distribution from the company's 401(k) plan.[28] Under those circumstances, the executive's deferral election must be completely canceled in full (*i.e.*, as opposed to merely being postponed or delayed). Any subsequent deferral election made after such cancellation will then be subject to the NDCP's and Code Section 409A's regular provisions governing deferral elections for the applicable period.

NDCP Hardship Distributions

In addition to cancellation of the executive's deferral election, if the existing NDCP document so provides, the executive may be permitted to receive distributions from his or her NDCP account upon incurring a severe financial hardship due to an unforeseeable emergency.[29] Whether the executive qualifies is based on the facts and circumstances.[30] An event constitutes an unforeseeable emergency if it arises from extraordinary and unforeseeable circumstances beyond the control of the executive and causes the executive a severe financial hardship.[31] A hardship qualifies as a severe financial hardship under Code Section 409A only if it cannot be relieved through compensation or reimbursement received from insurance or otherwise, by liquidation of the executive's other assets (to the extent such liquidation does not itself cause a severe financial hardship), or by ceasing future deferrals under the NDCP. Specific extraordinary and unforeseeable circumstances or events that could trigger an unforeseeable emergency include the following:

- The illness or accident of the executive or his or her spouse, beneficiary, or dependent;
- The imminent foreclosure of or eviction from the executive's primary residence;
- The need to pay medical expenses (including nonrefundable deductibles) or prescription drug medications;
- The need to pay for funeral expenses of the executive's spouse, beneficiary, or dependent; and
- Other similar extraordinary and unforeseeable circumstances arising out of events beyond the control of the executive.[32]

Unlike a hardship distribution from a 401(k) plan, payment of tuition and related expenses of post-secondary education for the executive or his or her spouse, children, or dependents does not qualify as an unforeseeable emergency under Code Section 409A.[33] Just as the 401(k) hardship standard may not be used for purposes of determining eligibility for a NDCP in-service withdrawal due to unforeseeable emergency, the same is true in the event that an NDCP participant is considered a "qualified individual" under the CARES ACT (*i.e.*, a person: (1) who is diagnosed with the virus SARS–CoV-2 or COVID-19 by a test approved by the Centers for Disease Control and Prevention; (2) whose spouse or dependent, as defined in Section 152 of the Code, is diagnosed with such virus or disease by such a test; or (3) who experiences adverse financial consequences as a result of being quarantined or furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury or its delegate) for purposes of receiving COVID-19 distribution from a qualified plan.[34] Accordingly, if the NDCP meets the qualified individual criteria, it will not automatically qualify such participant for a hardship withdrawal from the NDCP.

The amount distributed from the NDCP upon a qualifying unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any income taxes or penalties reasonably anticipated to result from the distribution).[35] When determining the amount necessary to satisfy the emergency need, the company must consider the additional compensation that the executive could obtain by canceling future deferral elections under all qualified plans as well as all NDCPs but does not have to consider available distributions or loans from a qualified plan or from another NDCP.[36] Whether an employee meets the Code Section 409A standard for a hardship withdrawal will depend on the specific facts and circumstances, and not every hardship created by the COVID-19 crisis will automatically meet the necessary criteria. Consequently, if a company has a hardship distribution provision in their NDCP, if they have not already done so, they should establish and document a prudent process to determine whether to approve any hardship distribution request they receive in 2020.

LOOKING AHEAD

From the Great Depression to the 2008 financial crises, businesses have long faced financial challenges during which they need effective leadership and strategic planning to endure and remain solvent. The obvious key difference that makes the current COVID-19 crisis that much worse is that what's at risk is not only the fiscal health of the companies but also the physical health of its employees and clients. Given the global impact of the virus and how it has altered not just business but so many other aspects of life from going on "as business as usual," its effect on executive compensation may not be front-page news—but it is nonetheless an issue that should be addressed by all businesses. As companies attempt to balance the need to preserve cash flow while retaining top executive talent and staying compliant with the complex tax laws governing deferred compensation, they will need to enlist the assistance of ERISA consultants, legal counsel, and tax advisors to make informed decisions for their executives and their businesses as a whole.

NOTES

1. § 4004(b) of the CARES Act.
2. § 4004(a)(1) of the CARES Act.
3. § 4004(a) of the CARES Act.
4. § 4004(a)(1) of the CARES Act.
5. § 4004(a)(2) of the CARES Act.
6. § 4116(a) of the CARES Act.
7. Treas. Reg. § 1.409A-1(d)(1).

8. Treas. Reg. § 1.409A-2(b)(1)(i).

9. Treas. Reg. § 1.409A-3(d).

10. *Id.*

11. Treas. Reg. § 1.409A-2(b)(1)(i).

12. Treas. Reg. § 1.409A-3(d).

13. Treas. Reg. § 1.409A-1(h)(1)(i).

14. Treas. Reg. § 1.409A-1(h)(1)(ii).

15. *Id.*

16. Treas. Reg. § 1.409A-3(g).

17. *Id.*

18. *Id.*

19. Treas. Reg. § 1.409A-2(b)(1)(i).

20. Treas. Reg. § 1.451-2.

21. *Id.*

22. *Id.*

23. *See* Treas. Reg. § 1.409A-1(h)(1)(ii).

24. *Id.*

25. *Id.*

26. *See* ERISA §§ 201(2), (301)(a)(2), and 401(a)(1).

27. Treas. Reg. § 1.409A-2(a)(1).

28. *See* Treas. Reg. § 1.409A-3(j)(4)(viii).

29. *See* Treas. Reg. § 1.409A-3(i)(3)(i).

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *See* § 2202(a)(4)(A)(ii) of the CARES Act.

35. Treas. Reg. § 1.409A-3(i)(3)(ii).

36. *Id.*

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