

Memorandum

Section 409A Deferred Compensation Issues Pertaining to COVID-19

April 23, 2020

Overview

This memorandum summarizes some of the potential deferred compensation tax issues under Section 409A of the Internal Revenue Code (“Section 409A”) confronting employers, employees and other service providers in light of the coronavirus disease 2019 (“COVID-19”) developments.

Section 409A provides detailed rules governing nonqualified deferred compensation arrangements. Failure to follow those rules could subject affected employees and other service providers to accelerated income taxation, together with an additional 20% penalty tax plus interest. Some of the recent economic challenges and workforce changes caused by COVID-19 have raised potential compliance and planning issues from a Section 409A standpoint. Set forth below are some of the more salient issues that clients may be facing during these uncertain times:

- **Same Year Salary Reductions or Deferrals.** Many companies have reduced or deferred employees’ salaries in response to the recent economic downturn. While salary reductions alone should not trigger Section 409A concerns, a company’s commitment to repay the forgone salary at a later date could run afoul of the timing rules under Section 409A which generally require salary deferral elections to be made prior to the year in which the relevant services are performed. In order to avoid subjecting any such delayed salary payments to Section 409A, such payments should be made to employees not later than March 15, 2021. Alternatively, an employer that does not commit to repay the forgone salary amounts (and is under no other legal obligation to repay) could unilaterally choose to repay the forgone salary amounts at any time of its choosing (even beyond March 15, 2021).¹
- **Separation From Service Determinations.** While Section 409A permits deferral arrangements to provide for payment to be made upon an individual’s separation from service, the Section 409A regulations include detailed rules defining when a “separation from service” will be deemed to have occurred (which may differ from determinations related to an individual’s termination of employment from a common law standpoint). Accordingly, employees who have been furloughed or whose services have been substantially curtailed due to COVID-19 may or may not be deemed to have experienced a “separation from service” for

¹ If this approach is pursued, employee communications should be crafted carefully to avoid statements that could create an expectation of deferred payment that might rise to the level of a “reliance” claim resulting in a “legal obligation” of payment which would implicate the deferred compensation rules of Section 409A noted above.

Section 409A purposes depending on the particular facts and circumstances. As a general rule, an individual will be deemed to have experienced a “separation from service” if the individual’s level of services is anticipated to permanently decrease to a level that is 20% or less than the individual’s average level of services provided over the preceding 36-month period. Conversely, if an individual is continuing to perform services at a level that is at least 50% of the individual’s average level of services provided over the preceding 36-month period, then the individual will be presumed not to have experienced a “separation from service” for Section 409A purposes. If an individual’s level of services decreases to a level that is between 20-50% of the individual’s historical level of service over the preceding 36 months, then the Section 409A regulations contemplate a facts and circumstances determination to ascertain whether a “separation from service” has occurred. Employees who are on a “bona fide leave of absence” (generally defined to include leave periods not exceeding six months or such longer periods during which the employee retains a legal or contractual right to reemployment) will not be deemed to have experienced a “separation from service” for Section 409A purposes. As noted above, a facts and circumstances analysis may be required to determine whether employees who have been furloughed will be deemed to be on a “bona fide leave of absence” or will be viewed as having separated from service for purposes of Section 409A.

- **Delayed Payments of Deferred Compensation.** A company may wish to delay payment of an existing deferred compensation obligation that is scheduled for payment during 2020. So long as the payment is made not later than December 31, 2020, the late payment will not violate the Section 409A timing rules. Alternatively, if having to make the payment on the scheduled date would “jeopardize the ability of [the company] to continue as a going concern” the company would be permitted under Section 409A to make the delayed payment in 2021 or later, so long as payment is made during its first taxable year in which the making of the payment would not have that effect. Additionally, deferred compensation arrangements may be eligible for “re-deferral” elections as further described below.
- **Re-deferral Elections.** An employee scheduled to receive payments under a deferred compensation plan in the near term might prefer to extend the deferral period if, for example, the deferred amounts are notionally invested in securities or other performance indices that currently reflect a depressed trading price which the employee anticipates may rebound in the longer term. Alternatively, an employer might wish to exercise a re-deferral election in order to preserve cash. Section 409A generally permits a re-deferral election to be made so long as the election is made at least one year prior to the scheduled payment date and the newly chosen date extends the deferral period by least five additional years.
- **Existing Contractual Obligations.** Some of the actions which an employer may be permitted to take under Section 409A (including as described in this memo) may require consent from the affected employees in order to avoid triggering potential contractual or severance liability to the affected employees for breach of contract or “good reason” claims related to delayed or reduced payments, if applicable.

- **Unforeseeable Emergency Distributions.** Section 409A allows a deferred compensation plan to permit accelerated distributions of previously deferred amounts or cancellation of an existing deferral election in the event of an “unforeseeable emergency” related to the service provider, so long as the accelerated payments are limited to the amounts reasonably necessary to satisfy the service provider’s emergency need. Section 409A generally defines “unforeseeable emergency” as including a severe financial hardship resulting from illness or accident, property loss or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the service provider’s control. We would expect that economic hardships resulting from COVID-19 would typically qualify as an “unforeseeable emergency.” Even if a deferred compensation plan does not currently provide for accelerated distributions or cancellations of deferral elections due to unforeseeable emergencies, the Section 409A regulations permit a plan to be amended at any time to allow for such distributions or cancellations.
- **Death/Disability Distributions.** Section 409A permits deferred compensation plans to provide for payments to be made upon an employee’s death or “disability” (as defined under Section 409A). Even if a plan does not currently provide for such payments, Section 409A permits a plan to be amended at any time to incorporate a provision providing for accelerated payment upon death or disability. The increased instances of death and disability among active employees suffering from COVID-19 (and corresponding immediate cash needs by the employees’ families) might prompt employers to consider amending existing plans to provide for this type of accelerated payment.
- **Plan Terminations.** Section 409A permits a company to unilaterally terminate and pay out deferred compensation plans on an accelerated basis under limited circumstances. Generally, a company that wishes to terminate a deferred compensation plan in the ordinary course of business would be permitted to do so provided that (i) the plan termination does not occur proximate to a downturn in the company’s financial health, (ii) all similar “types” of deferred compensation plans are terminated, (iii) the accelerated payments are made no earlier than 12 months and no later than 24 months following the corporate action terminating the plan and (iv) no new similar kind of deferred compensation plan is established by the company until at least three years have passed from the plan termination date. The determination of whether a company has incurred a downturn in its financial health for purposes of clause (i) of the preceding sentence may require a facts and circumstances analysis.

For more information regarding Section 409A, please contact a member of the Firm's Executive Compensation and Employee Benefits Practice Group. Additional general guidance on matters related to COVID-19 can be found [here](#).

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