

Possible Options for Participant Relief Under Section 409A Plans in the Time of Coronavirus

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The coronavirus pandemic has caused widespread economic uncertainty and unanticipated liquidity issues for a wide range of individuals, including plan participants of nonqualified deferred compensation plans. In these precarious times, many employers are seeing an increase in requests from plan participants for immediate distributions of deferred compensation from their nonqualified plan accounts.

One of the stated policy goals of Internal Revenue Code (“Code”) section 409A was to prevent executives from accessing nonqualified plan benefits early in response to a financial downturn. Thus, even during the coronavirus pandemic, the IRS has continued to apply the strict limits of Code section 409A to subject nonqualified deferred compensation. Although many employers may understandably wish to help employees access their benefits during these unprecedented times, a failure to comply with the Code section 409A distribution rules can potentially cause severe tax consequences for employees (as well as reporting and withholding obligations for employers), resulting in more harm than good.

This article is intended to help employers understand their options under Code section 409A and implementing guidance (“Code section 409A”) to help their employees weather the coronavirus pandemic. In general, Code section 409A provides participants with a limited ability to access deferred compensation in the event of an unforeseeable emergency, and also offers employers (but not participants) some discretion to cancel future deferral elections (but not distribute benefits) in certain circumstances. However, it is important that employers understand the limits of these rules before taking action.

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Unforeseeable Emergency Distributions

Code section 409A generally permits payment of benefits under a nonqualified plan only upon certain limited payment “triggers,” and imposes severe tax penalties to participants for noncompliance. Among other triggers, Code section 409A permits plans to pay benefits to a participant in connection with an “unforeseeable emergency.” The plan document must specifically permit distributions upon an unforeseeable emergency. However, an employer generally may amend a plan at any time to permit unforeseeable emergency distributions.

Experiencing hardship during the coronavirus pandemic may not be sufficient to constitute an “unforeseeable emergency” for Code section 409A purposes. In order to qualify for an unforeseeable emergency distribution, a participant must demonstrate that he or she has experienced a *severe financial hardship* resulting from:

- an illness or accident of the participant or his or her spouse, beneficiary, or dependent;
- the loss of the participant’s property due to casualty; or
- other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the participant’s control.

Thus, although the coronavirus pandemic may constitute an extraordinary and unforeseeable circumstance that is beyond the participant’s control, the participant must also demonstrate that he or she is experiencing a severe financial hardship caused by the pandemic.

Under the Code section 409A rules, whether an unforeseeable emergency exists is based on all the relevant facts and circumstances of each case. Events that *may* warrant an unforeseeable emergency include the need to pay for substantial medical expenses, funeral expenses, or to prevent an imminent foreclosure or eviction from the participant’s primary residence. In contrast, the payment of college tuition and the purchase of a home generally do not qualify as unforeseeable emergencies.

Ultimately, employers will have to evaluate each request for an unforeseeable emergency distribution on a case-by-case basis, with particular focus on whether an immediate distribution is required to meet a severe financial hardship. For example, a plan participant who requests a distribution of nonqualified plan funds to cover funeral expenses related to the unexpected death of a spouse due to the coronavirus may be experiencing an unforeseeable emergency under Code section 409A. However, a plan participant’s inability to pay his or her mortgage on a second home due to the coronavirus likely would not by itself be an unforeseeable emergency under Code section 409A. Similarly, if the participant remains employed and continues to receive a similar salary and other benefits as before the coronavirus related emergency, it may be difficult for the employer to determine that a coronavirus related emergency alone resulted in an unforeseeable emergency for that participant.

Even if a nonqualified plan participant is able to demonstrate that he or she faces an unforeseeable emergency in connection with the coronavirus pandemic, Code section 409A limits unforeseeable emergency distributions to amounts reasonably necessary to satisfy the emergency need (which may



include amounts necessary to pay any reasonably anticipated income taxes or penalties). Further, nonqualified plans may permit distributions for unforeseeable emergencies only to the extent the hardship cannot be relieved by insurance, liquidation of other assets (to the extent the liquidation of such assets would not itself cause severe financial hardship), or by cessation of deferral elections under the plan. Thus, a nonqualified plan participant must exhaust other possible avenues of financial relief before accessing his or her deferred compensation. However, an employer is not required to take into account additional compensation that may be available from a qualified plan, including any loans available thereunder.

Cancellation of Deferral Elections

Even if a nonqualified plan participant experiences financial troubles as a result of the coronavirus pandemic, he or she may still fail to meet Code section 409A's strict unforeseeable emergency requirements. To make matters worse, if such participant previously elected to defer compensation to his or her nonqualified plan in 2020, he or she may be disappointed to learn that Code section 409A generally prohibits participants from cancelling nonqualified plan deferral elections after they have become effective. However, Code section 409A permits an employer to use its discretion to cancel such elections following a participant's 401(k) plan hardship distribution (as well as in connection with an unforeseeable emergency), and many nonqualified plans provide for such cancellation automatically. Further, recent IRS guidance expanded this rule to also encompass "coronavirus-related distributions" (CRDs) under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. IRS Notice 2020-50 (June 19, 2020). Thus, even if a participant's circumstances do not rise to the level of an unforeseeable emergency under Code section 409A, he or she may still experience some relief in the form of the ability to cancel future deferrals if he or she qualifies for a 401(k) hardship distribution or a CRD.

401(k) Plan Hardship Distributions

Although conceptually similar, 401(k) plan hardship distribution requirements are generally easier to satisfy than the Code section 409A unforeseeable emergency requirements. A 401(k) plan distribution may be made on account of hardship if the distribution is made due to an immediate and heavy financial need of the employee (rather than a severe financial hardship) and the distribution is necessary to satisfy the financial need. Unlike unforeseeable emergency distributions, 401(k) plan hardship distributions may be made on account of voluntarily incurred expenses, such as costs related to the purchase of a principal residence or payment of tuition for a plan participant's spouse, child or dependent. However, like unforeseeable emergency distributions, 401(k) plan hardship distributions may not exceed the amount necessary to satisfy an immediate and heavy financial need. Further, a plan participant must have insufficient cash or liquid assets reasonably available to satisfy the need, and he or she must have obtained all other currently available distributions under the plan and all other plans of deferred compensation (qualified or nonqualified) maintained by the employer.

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Coronavirus Related Distributions

To streamline participants' access to their qualified plan retirement funds during the coronavirus emergency, the CARES Act permits qualified 401(k) plan participants to obtain CRDs of up to \$100,000 on or after January 1, 2020 and before December 31, 2020, provided the employer has opted to allow CRDs. CRDs are available to plan participants diagnosed with the coronavirus or with diagnosed spouses or dependents, as well as plan participants who experience adverse financial consequences as a result of the coronavirus pandemic (whether due to quarantine, furloughs, layoffs, rescinded or delayed job offers, lack of childcare or closing or reducing the hours of a business). Importantly, an employer may rely on the participant's self-certification that he or she qualifies for a CRD, and the amount of a CRD is not limited to the needs of the participant.

Although CRDs are not technically hardship distributions under the 401(k) regulations, IRS Notice 2020-50 provides that a CRD is treated as a hardship distribution for purposes of the regulations under Code section 409A. Thus, a nonqualified plan may provide for the cancellation of a participant's deferral election, or such a cancellation may be made, if a participant takes a CRD. In addition, if plan requires cancellation of deferral elections upon a 401(k) plan hardship distribution, then pursuant to Notice 2020-50, a plan participant's deferral elections must be cancelled if he or she receives a CRD (though the employer may amend the plan prospectively to avoid this result).

Although Notice 2020-50 provides welcome relief to nonqualified plan participants, it raises some administrative issues for employers. Specifically, because CRDs are technically not hardship distributions under the 401(k) plan rules, they were not considered hardship distributions for purposes of Code section 409A prior to the publication of Notice 2020-50. Therefore, the nonqualified plan deferral election of a participant who received a CRD prior to the publication of Notice 2020-50 should not have been cancelled solely due to the CRD. However, Notice 2020-50 does not indicate a specific date on which the guidance connecting CRDs and 401(k) plan hardship distributions should be considered effective. Thus, it is currently unclear how the guidance under Notice 2020-50 applies to *nonqualified* plan deferral elections for participants who received a CRD in 2020 before the publication of Notice 2020-50. This is a particular concern where the plan specifically requires the cancellation of deferrals for participants who receive a 401(k) plan hardship distribution. Employers faced with this situation should carefully review the terms of the applicable plan and consult with counsel regarding how to proceed.

Participant Discretion Not Permitted

Importantly, Code section 409A does *not* permit participants to directly or indirectly elect whether their deferral elections will be cancelled. Thus, a participant may elect a 401(k) hardship distribution or CRD, but he or she may not instruct the employer as to whether and how the 401(k) plan distribution will impact his or her nonqualified plan deferral elections. In addition, in determining whether a participant has been provided with such discretion, the Code section 409A rules take into account all relevant facts and circumstances, including whether similarly situated participants have been treated

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differently. Thus, even where the plan document does not specifically require cancellation of deferrals for participants who receive a 401(k) plan hardship distribution, it is important for an employer to treat all participants consistently, and not on a case-by-case basis. If an employer intends to cancel deferral elections for some, but not all, participants who receive a 401(k) plan hardship distribution or CRD, then the employer should establish objective guidelines for identifying which participants' elections will be cancelled.

Next Steps

At present, absent legislation from Congress, we do not anticipate any Code section 409A specific relief will be issued with respect to nonqualified plan sponsors and participants in connection with the coronavirus pandemic. Thus, employers should focus on the limited avenues of relief that do exist, keeping in mind that although the coronavirus pandemic may have caused financial difficulty, the strict rules under Code section 409A regarding unforeseeable emergency distributions (and potential tax consequences for noncompliance) continue to apply. In addition, employers should review their plan documents to determine whether the plan terms require deferral cancellations in the event a participant receives a CRD.

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