NEWPORT
retirement services

COVID-19 and Non-Qualified Deferred Compensation Plans Frequently Asked Questions

This document addresses questions Newport is receiving from non-qualified plan sponsors whose participants are impacted by the COVID-19 (coronavirus) outbreak. Answers are current as of April 8, 2020. This FAQ will be updated for future changes.

This FAQ focuses primarily on:

- Employers who have reduced employee compensation, furloughed or laid off employees in response to the COVID-19 pandemic.
- The impact of compensation package changes on non-qualified deferred compensation plans.
- The extent to which ongoing plan administration may be impacted by COVID-19 and steps employers should consider to provide assistance to plan participants.

1. Will there be legislative relief for non-qualified plans comparable to the relief provided to tax-qualified plans?

The CARES Act allows participants impacted by COVID-19 to borrow from a tax-qualified plan or request a withdrawal of up to $100,000. See Newport's FAQ for tax-qualified plans here. **However, CARES Act relief does not extend to non-qualified plans at this time**.

2. We have reduced our employees' salaries in response to COVID-19. Some participants have made substantial deferrals, which further reduce their take-home pay. Must the elected deferrals continue, or can the participant make a new election based on the change in circumstances?

Deferral elections generally must continue in effect regardless of the reduction in the participant's compensation.

Some participants may have elected to defer a specific dollar amount. The dollar amount should continue to be deducted from payroll based on the sponsor's practices for deducting deferrals. For example, if the annual deferral is $48,000 and the employer spreads the deferral over 24 pay periods, the $2,000 per-payroll deduction should continue. If reduced compensation cannot support the full amount, the deferral may include the total amount of the paycheck. The dollar amount that is not deferred in that payroll should be deducted when full compensation is restored during 2020. Plan provisions may vary, so sponsors are encouraged to review specific plan provisions with their counsel to determine the specific impact on plan participants.

3. We have furloughed or laid off many of our employees. Have they "separated from service"?

A "separation from service" is one of the six permitted payment events under §409A. The terms "furlough" or "layoff" have no legal significance in determining whether a separation from service has occurred under §409A.

In general, an employee "separates from service" when the employer and employee no longer reasonably anticipate that the employee will perform future services after a certain date. If the "layoff" or "furlough" is temporary, the parties may reasonably expect a return to service. In that case, separation from service generally will not occur.

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The determination of whether a separation from service occurred is a "facts and circumstances" determination that employers should make with the advice of counsel. Factors that indicate an anticipated return to service include the availability of alternative employment, the extension of benefits during the furlough/layoff that are normally offered to employees only, and/or an open offer to return to active service once the COVID-19 "shelter in place" restrictions are lifted.

Because furloughed and laid-off workers may not have "separated from service" and may not have paychecks for some time, sponsors can expect they will receive requests from impacted employees for "unforeseeable emergency" withdrawals.

4. Does COVID-19 qualify as an "unforeseeable emergency"?

Some sponsors have asked whether non-qualified plan deferrals may be reduced or suspended, or whether furloughed/laid-off employee may obtain a distribution from the plan as a result of emergency actions taken by the employer in response to COVID-19.

Although most employers would certainly regard COVID-19 as an unforeseeable national and company emergency, the definition of an unforeseeable emergency under § 409A defines an emergency based on the individual participant's situation. An employer cannot assume that a reduction in pay or furlough or layoff would automatically constitute an unforeseeable emergency for all of the impacted participants. The participants must request emergency relief, and individually must be able to meet the conditions of an "unforeseeable emergency" as defined under § 409A.

5. What constitutes an "unforeseeable emergency"?

Unforeseeable emergencies are one of the six permitted distribution events under a non-qualified deferred compensation plan. Non-qualified plans must be written, which means the plan document must authorize cancelations and distributions from the plan due to an unforeseeable emergency. Plans that do not have the provision may be amended to add it, and the added provision may apply to existing account balances.

An "unforeseeable emergency" is a severe financial hardship to the employee resulting from an illness or accident of the employee, the employee's spouse, dependents and beneficiaries or the loss of property due to casualty "or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the employee." Among other specified events, the **imminent foreclosure or eviction** from the employee's primary residence may constitute an unforeseeable emergency. The payment of credit card debt generally would not constitute an unforeseeable emergency. See Rev. Rul. 2010-27 (addressing 457(b) plans, but applying the ruling by analogy to non-qualified deferred compensation plans subject to § 409A).

A distribution on account of an unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by the liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or by cessation of deferrals under the plan. While participants are not required to withdraw or borrow from a 401(k) plan, they will need to inventory their other assets to identify the amount of the unmet emergency need.

If a participant meets the definition of an unforeseeable emergency, current year deferrals will be canceled for the remainder of the year. If the cancelation of deferrals is insufficient to meet the need, a distribution can be made from the plan, up to the amount reasonably necessary to meet the need, plus an amount to pay reasonably anticipated state and federal income taxes on the distribution.

Before 2020, participants taking a safe harbor hardship withdrawal from a 401(k) plan were required to suspend all deferrals for six months, including any deferrals to a non-qualified deferred compensation

plan. The § 409A regulations published in 2007 contain a companion provision that permits the cancelations of deferrals for the years in which the suspension requirement under the 401(k) plan applies. However, starting in 2020, 401(k) plans may not require a suspension of deferrals from funded retirement plans. Although the prohibition on suspension does not extend to unfunded non-qualified plans, deferrals to non-qualified plans also are not required to be suspended. As a result, cancelation of deferrals generally will not occur under the non-qualified deferred compensation plan as a result of a 401(k) hardship distribution.

6. What would constitute an "imminent foreclosure or eviction" from a primary residence?

Unforeseeable emergencies are based upon a review of all of the facts and circumstances and should be reviewed with counsel. A layoff or reduction in pay, by itself, generally would not constitute an imminent foreclosure or eviction. At a minimum, the mortgage holder or landlord must be taking affirmative legal steps to foreclose upon the home or evict a tenant from the premises.

The CARES Act provides that individuals impacted by COVID-19 may request forbearance from mortgage payments if the FHA backs the mortgage. The lender is also temporarily prohibited from initiating foreclosure proceedings. Participants may search the Fannie Mae and Freddie Mac websites to determine if the FHA backs their mortgages. Landlords whose buildings are financed by FHA mortgages and who have obtained COVID-19 relief from the lender may not evict their tenants as a condition to receiving relief from the FHA. Aside from FHA relief, certain lenders have adopted forbearance policies, and some states and counties have enacted legislation or implemented rules suspending all foreclosure and eviction actions.

Unemployment benefits would be considered as an available resource that would reduce the amount of any unforeseeable emergency withdrawal from a non-qualified plan. Depending on the applicable state's laws, furloughed/laid-off employees may qualify for unemployment benefits even though technically "employed" by their employer. States entering into a Federal Pandemic Unemployment Compensation agreement with the federal government will be able to increase weekly benefits by $600. The period for increased benefits ends July 31, 2020, or any earlier date under the agreement between the employee's state government and the Department of Labor.

7. Are there any other ways to provide payments to participants?

The options are limited. By design and the legal requirements for obtaining income tax-deferral, non-qualified plans are long-term capital accumulation plans with very limited options for early payment.

The limited options include the employer's ability to liquidate small account balances ($19,500 or less in 2020) and the participant's ability to withdraw his or her account from a pre-409A grandfathered plan. The "small balance" provision includes all similar deferral accounts under § 409A and requires a complete distribution of all such accounts. The withdrawal provision must be authorized under the terms of the grandfathered plans, and requires a reduction in the participant's account balance as consideration for the withdrawal.

8. May employers terminate the plan to pay participants?

A pre-409A plan may be terminated and the benefits paid. A plan subject to §409A may not be terminated if the termination is proximate to a downturn in the financial health of the employer. If the employer satisfies this requirement, the §409A regulations require termination payments to be delayed 12 months after the date all binding, irrevocable actions have been taken by the employer to terminate the plan.

9. As part of our compensation package restructuring, we are modifying our annual bonus program to reflect the change in business conditions. How will this affect bonus deferrals?

Bonus restructuring may impact the ability to defer performance-based bonuses during 2020. Sponsors are encouraged to review their revised bonus programs with counsel to determine if the mid-year enrollment for performance-based pay should proceed and which employees should be included in the enrollment. Sponsors should be aware of the following requirements:

- The performance period must be at least 12 months. Does the revised bonus shorten the performance period?
- The performance criteria must be established within the first 90 days of the performance period. Does the revised bonus program change the criteria after the 90-day period (e.g., after March 30, 2020, for a calendar fiscal year bonus)? Note that a change in the bonus potential may not necessarily constitute a change in the criteria for earning the bonus.
- The participant must be employed continuously from the time the criteria are established to the time the election is made. Employers will need to evaluate whether employees who have been "furloughed," then re-engaged by June, have been "continuously employed."

If the annual bonus was enrolled in 2019 under the "prior year" rule, the elections generally would continue in effect for 2020 regardless of changes to the criteria for earning the bonus. Other election timing rules also may be available if the bonus is subject to a vesting schedule.

10. The pay reductions we've implemented to date are temporary, and we intend to make them up later in 2020 and 2021. How does this impact the participant's deferral elections in 2020?

There are at least two issues sponsors should be aware of:

- The deferral election in effect for 2020 will continue to apply to all future payrolls that contain compensation earned in 2020, regardless of when those payrolls occur (including any payrolls that may extend into 2021).
- Extending payments of 2020-earned compensation into 2021 by itself may result in deferred compensation, apart from any deferral elections participants may have made under the plan. Section 409A will apply to any amounts the participant did not defer, and that is paid after March 15, 2021. Section 409A will apply to any amounts that are subject to an existing deferral election regardless of when the payroll occurs (described in the bullet above). Employers who are considering deferred make-up payments should plan with their payroll providers to segregate the amounts earned in 2021 from the amounts earned in 2020 that may be included in the same payroll so that the correct deferral election can be applied to the correct amount of compensation.

There is a distinction between paying 2020 earned compensation in 2021 and paying at a higher rate for services performed in 2021. For example, a reduction in salary of 50% in 2020, coupled with a promised increase in base pay of 125% in 2021, should not result in deferred compensation as long as the increased pay is based solely on services performed in 2021.

These issues are very fact-specific and will require the employer's careful review with counsel.

11. We are suspending matching contributions under our 401(k) plan. We are considering the same for the non-qualified plan. Are we allowed to suspend or cancel the non-qualified plan's match?

The ability to suspend or cancel a non-qualified plan's match will depend on the terms of the plan document and the match that was offered to the participants during the 2019 enrollment. Some plans contractually obligate the employer to make the match each year. Others provide for a discretionary match, but a specific match is promised during enrollment as an inducement to defer under the plan for the current plan year. Still, other plans state that the match is fully discretionary and/or may make a match only if the full match is made to the 401(k) plan.

The decision to suspend a matching contribution to a non-qualified plan has slightly different considerations from the decision to suspend a matching contribution to the 401(k).

- Suspending the 401(k) match is typically driven by a desire to maximize cash flow to the employer. Suspending a matching contribution to a non-qualified plan may or may not impact cash flows, depending on whether the employer is obligated to make concurrent contributions to a rabbi trust. If there is no funding obligation (legally or under the employer's informal financing policy for the plan), the matching contribution is a notional liability that will not impact cash flows in 2020.
- To the extent the match is tied to a maximum 401(k) matching contribution, the decision to eliminate the 401(k) match could automatically eliminate the non-qualified match. The result depends on the specific non-qualified plan language. In some non-qualified plans, the match is a set formula offset by actual contributions to the 401(k) plan. Canceling a 401(k) match may shift some or all of the match to the non-qualified plan.
- Suspending the 401(k) match without a suspension/cancelation of the non-qualified match may present other issues for HR, including questions about equitable treatment of the company's employees. Similar to voluntary waivers of compensation by the company's executives, the participants in the plan generally may waive any legal rights they may have to a matching contribution.
- Similar to the "make up" payroll issue, a decision to make up a suspended or waived match in 2020 with a larger match in 2021 or later years could raise election timing issues under § 409A. The issue (and solution) will depend on whether a legally binding right to the make-up match existed in 2020.
- Matching contributions to a defined contribution plan are included "payroll costs" eligible for a guaranteed SBA loan under the Paycheck Protection Program. Although not clear, it seems unlikely that "payroll costs" would include matching contributions under a non-qualified plan since the match is a notional liability, and the assets in a rabbi trust are corporate assets that may or may not be used to pay matching account liabilities. See the Treasury's Paycheck Protection Program FAQ Q7, for further information.

As with the other topics addressed in this FAQ, the ultimate answer will depend on a review of the specific plan document and participant elections with the employer's attorneys.

12. The CARES Act allows us to postpone required minimum distributions from our 401(k) plan that would have begun on April 1, 2020. The purpose of this provision is to avoid liquidating participant accounts at current depressed equity values. What flexibility is there to do something similar for non-qualified plan participants with scheduled plan distributions commencing in 2020?

Treasury regulations under § 409A provide that a payment to a participant is considered to be timely if it is made not later than December 31 of the scheduled payment year. This provision may provide sponsors with some flexibility in delaying payments that would otherwise be made at a time when market values are depressed to a later date in 2020. The plan should be reviewed with counsel to determine the flexibility that a sponsor may have to delay the actual payment date as well as the valuation date for the payment. Consistent with other provisions in the §409A regulations allowing limited employer discretion, the decision should be made solely by the employer, not in response to specific participant requests and all similarly situated participants should be treated uniformly.

If you have any questions, please contact your Newport representative.

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