WRMarketplace

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TOPIC: Deferring Compensation to Conserve Cash During the COVID-19 Economic Crisis

MARKET TREND: Many companies are looking for short-term strategies to conserve cash during the COVID-19 economic crisis. There are several compensation-based strategies that could be used for this purpose.

SYNOPSIS: While a number of companies have cut compensation to employees due to the economic damage caused by the COVID-19 pandemic, other companies withless dire business conditions may still need to deal with shorter-term cash constraints. Companies looking to defer current cash payments to top-paid employees could consider several strategies, including (1) deferring current 2020 salary payments, (2) delaying payments under nonqualified deferred compensation (NQDC) plans, (3) delaying rabbi trust contributions used to informally fund NQDC plans, or (4) granting equity compensation awards in lieu of 2020 salary payments. Each of these strategies includes several design choices and a number of tax, legal, and other considerations that should be reviewed.

TAKEAWAYS: Companies looking to conserve cash through any of these strategies should carefully consider the potential issues and challenges with the desired approach. Each company will have a unique circumstance. Each strategy requires good documentation and communication.

The economic crisis triggered by the COVID-19 pandemic has hit hard the cash flow at many companies, especially those dependent on retail consumers. Many public companies have announced executive-level temporary pay cuts to help conserve cash, often alongside broader workforce actions such as furloughs and layoffs.[1]

There are many other companies that may not be as hard-hit by the pandemic and that do not need cuts in pay, but that may still desire short-term cash flow relief. This article describes four strategies for these companies to address short-term cash-flow challenges by deferring (rather than cutting) compensation. These strategies focus on actions on compensation related to a company's management or highly compensated employees – sometimes referred to as the "top hat" group.[2]

STRATEGY 1: DEFERRAL OF 2020 SALARY PAYMENTS

Description: Companies can conserve cash by having a portion of 2020 base salary payable to members of the top hat group deferred and paid at a later date.

Key Design Choices: This strategy may involve either a mandatory or elective deferral. Deferrals can only apply prospectively to salary that has not yet been earned. Some key design choices include:

- How long will the deferral period be? Payments could be deferred until later this year or early next year, or until some later date. The arrangement should also address timing of payment if the employee terminates employment before the scheduled payment date.

- Will the deferred amounts receive interest or other adjustments for deemed investment returns to compensate for the payment delay?

- Will there be any other incentives to encourage participation or help make participants whole for the risk of delayed payments? For example, some companies have offered a retention bonus if the employee remains with the company through the deferred salary payment date.

Key Considerations: A salary deferral program must consider issues related to the timing of income and payroll taxes, status as an ERISA-covered plan, and state wage and hour laws.

A key initial key issue is whether IRC Section 409A will apply to the arrangement. Section 409A applies to any arrangement in which compensation that has become earned and vested in one year could be payable later than March 15 of the following year. A short-term 2020 salary deferral arrangement with a payment date in all cases before March 15, 2021 should therefore avoid Section 409A as a "short-term deferral." But if the arrangement could result in payment of deferred 2020 salary after March 15, 2021, the arrangement will need to comply with Section

[1] The consulting firm Pearl Meyer notes that about 9% of the Russel 3000 have disclosed significant executive-level pay actions, with about 8% implementing significant pay cuts for their CEOs and other key executives. See *COVID-19 Discussion Points for Your May/June Comp Committee Meetings*, May 2020, here: https://www.pearlmeyer.com/blog/covid-19-discussion-points-for-your-may-june-comp-committee-meetings.

[2] For a discussion about how to identify a company's "top hat" employees, see the October 2018 Marketplace article, *"Top Hat" Plans -- What are They and How Do You Know If You Have One"*

409A. Section 409A includes strict rules on timing of deferral elections and timing and form of payments. If the company already has a NQDC plan that permits elective deferrals, it may be difficult to establish a new mid-year elective deferral arrangement with a post-March 15, 2021 payment date that is subject to 409A. Failure to comply with Section 409A's requirements may trigger accelerated income taxes for the employee with 20% (or more) in additional taxes.

Even if the salary deferral arrangement is not subject to Section 409A as a short-term deferral, the deferred amounts could potentially be taxable at the front-end when deferred under the long-standing constructive receipt doctrine, especially if the arrangement is based on an employee election. Compensation may be considered taxable when "constructively received" if the employer is ready, willing, and able to pay earned compensation and there is no substantial limitation or restriction on the employee's ability to demand receipt of the payment. For example, if an employer stands ready to make a salary payment to an employee, and the employee rejects the payment and asks for it to be paid at a later date, the IRS likely would say that the employee constructively received the payment at the front end. Pre-Section 409A case law on the application of the constructive receipt doctrine for elections to defer compensation often resolved in favor of the taxpayer, but the outcome depends on the specific facts. The risk related to constructive receipt should decrease depending on how long in advance of the salary period any deferral election is made and the length of the deferral period.

The timing of FICA taxes (i.e., social security and Medicare taxes) follows a different set of rules under IRC Section 3121(v). Under the so-called "special timing rule" under Section 3121(v), deferred salary should be subject to FICA taxes in the payroll period when earned, rather than when paid. This FICA tax special timing rule applies whether or not the salary deferral arrangement is subject to Section 409A, and whether or not it is elective or mandatory.

In addition to tax considerations, the deferral arrangement should be reviewed to determine whether it constitutes a "plan" that is subject to ERISA. An arrangement that provides for a systematic deferral of compensation until termination of employment or beyond may be an ERISA "pension plan." Assuming participation is limited to the top hat group of employees, the arrangement would need to meet certain ERISA requirements, including having a claims procedure. The company would also need to make a one-time "top hat" filing with the Department of Labor in order to avoid ERISA reporting and disclosure requirements. A short-term deferral, however, likely should not be an ERISA plan, but instead would be better characterized as a non-ERISA "payroll practice."

State wage and hour laws may also impose requirements. For example, those laws may require employee consent to any delay in payment of earned salary.

In summary, a short-term salary deferral program (as a means to address a short-term cash flow concern) will likely raise fewer legal issues than an arrangement with longer-term deferral. Any deferral program should be clearly documented in writing, communicated, and reviewed with legal counsel before it is implemented.

STRATEGY 2: DELAYING DEFERRED COMPENSATION PAYMENTS

Description: Companies that offer NQDC plans may have employees who have a right to receive a payment in 2020, e.g., as the result of a separation from service. For companies that make those payments out of working capital (rather than a rabbi trust), current cash flow can be preserved to the extent that those payments can be delayed.

Key Design Choices: The key design question will be the length of the payment delay. The answer must be based on the considerations discussed below, especially compliance with Section 409A and the terms of the NQDC plan.

Key Considerations: With limited exceptions, Section 409A prohibits delaying payment of deferred compensation from the timing specified by the plan. For example, if the plan says payment must be made in a lump sum within a short period of time after separation from service, then Section 409A generally will require payment within that time period.

There are a couple of potential exceptions that may be helpful, however, for addressing a short-term cash flow issue.

First, under Section 409A, a payment is considered made on the specified payment date required by the plan if it is actually paid no later than the later of (i) the end of the calendar year in which the Section 409A payment event (e.g., separation from service) occurs, or (ii) the fifteenth day of the third calendar month after the calendar month in which the Section 409A payment event occurs. This rule means that a NQDC plan payment triggered by a Section 409A payment event in 2020 could be delayed until December 31, 2020 without violating Section 409A.[3]

Second, Section 409A offers a more limited payment delay exception for company's experiencing more pressing financial challenges. Section 409A allows delayed payments for so long as current payment of salary might reasonably threaten the ability of the company to continue as a going concern. The IRS views this special rule as a narrow one, however, and it likely will apply only in cases of severe financial distress.

In either case, the terms of the NQDC plan should be reviewed to determine whether the company has flexibility to delay payment within the parameters permitted by Section 409A. If the plan does not permit delayed payment, even if otherwise permitted by Section 409A, the company could face a legal claim from an employee based on the plan provisions. The risk of claims may be mitigated if the deferral period is short (e.g., until year end) and the amount is appropriately adjusted with interest or other earnings to compensate for the payment delay.

STRATEGY 3: DELAYING RABBI TRUST CONTRIBUTIONS

Description: Companies that use a rabbi trust to informally fund their NQDC plans could delay funding the rabbi trust and instead use the cash that would have otherwise been contributed to the rabbi trust as working capital.

Key Design Choices: The key design question will be how long should the rabbi trust contribution be delayed. The delay in contribution to the rabbi trust should not change the amount credited to a participant's deferred compensation account or the notional earnings credited to that account.

Key Considerations: NQDC plans must be unfunded, unsecured arrangements in order to comply with tax requirements and ERISA. Employers will often informally fund plans by

[3] If the 2020 payment event occurs later in the year, payment could be delayed into early 2021 (i.e., the payment for a payment event in October 2020 could be paid as late as January 15, 2021; the payment for a payment event in November 2020 could be paid as late as February 15, 2021; and the payment for a payment event in December 2020 could be paid as late as March 15, 2021).

contributing the otherwise deferred cash compensation to a rabbi trust. Rabbi trusts, especially for elective NQDC plans, are often set up to be irrevocable. That is, once an amount is contributed to the rabbi trust, those amounts may be used only for the purpose of paying NQDC plan benefits, or in the case of the company's insolvency, being available for payment to the company's creditors.

But unless the NQDC plan mandates use of a rabbi trust, the company is normally free to choose whether or not to make contributions into the rabbi trust. An amount not contributed to the rabbi trust can be used for any purpose.

Some plans or key employee agreements, however, may specify that amounts must be contributed to a rabbi trust. In those cases, companies may need to consider risk of participant claims if rabbi trust contributions are delayed without participant consent. Arguably, participants should not have any loss if rabbi trust contributions are delayed, since the plan benefit is not defined by the rabbi trust, but by the plan's notional account balance which does not need to be impacted by the delayed rabbi trust contribution.

When a delayed rabbi trust contribution is later made, the amount to be contributed may need to be adjusted based on any corresponding earnings adjustments to the related deferred amounts in the NQDC plan for the delayed period.

STRATEGY 4: EQUITY FOR CASH ARRANGEMENTS

Description: For companies that have equity compensation plans already in place, the company could consider making current equity compensation awards in lieu of cash salary payments as a way to conserve cash flow.

Key Design Choices: The key design question will be what form of equity awards to use, which depending on what is authorized by the underlying equity compensation plan, could include fully vested shares, stock options, or restricted stock units. Because the award would be made in lieu of earned salary, presumably shares of restricted stock that would be subject to a substantial risk of forfeiture would not be used.

Key Considerations: Using equity awards in lieu of earned cash compensation raises a number of potential considerations under the company's equity compensation plan, including:

- Does the company have an equity compensation plan already in place? If not, a plan would have to be adopted, a number of shares of company stock would need to be set aside and reserved, and in many cases (such as for public companies) the plan may need shareholder approval.

- Will the equity plan share pool have a sufficient number of shares for the awards, and how quickly will this added share use deplete the existing share pool?

- Does the equity plan authorize the type of award contemplated? Not all equity plans permit grants of fully vested shares, for example.

- How will the number of shares, options, or restricted stock units be determined? Typically, the cash amount would be divided by the accounting value of the applicable award, which would usually be the fair market value of the stock on the grant date in case of shares or restricted stock units or the Black-Scholes value for options. In any of these cases, the company should also address any rounding protocols to avoid fractional shares.

- If restricted stock units are used, when will the units be settled by delivery of shares?

- For private companies, how will share value be determined? If stock options are used, the exercise price should not be less than the grant date fair market value of the shares for the options to be exempt from Section 409A.

- How will tax withholding be satisfied? Will employees be required to pay cash for the required withholding, or will the award be "net settled" (by delivering only the net shares after tax withholding). A net settled award will provide less cash flow relief, because the cash needed to cover the required tax withholding will deplete company cash reserves.

From a tax perspective, awards of vested shares or stock options in lieu of current cash compensation should not create any issues under Section 409A, as neither the salary or the vested shares/stock options should be subject to Section 409A. Stock options, if properly structured, would not be taxable until later exercised (or possibly later than that if granted as an "incentive stock option" under IRC Section 422). If restricted stock units are used, Section 409A could apply if the settlement date for the units is later than March 15, 2021. In that case, compliance with Section 409A would be required.

Use of equity compensation also requires a legal review for compliance with applicable securities laws. Consequently, use of equity compensation in lieu of base salary can raise more issues and complexities than a simple, short-term deferral if the primary goal is simply a short-term conservation of cash. But using equity compensation may create better incentives to drive long-term success of the company through and beyond the end of the pandemic.