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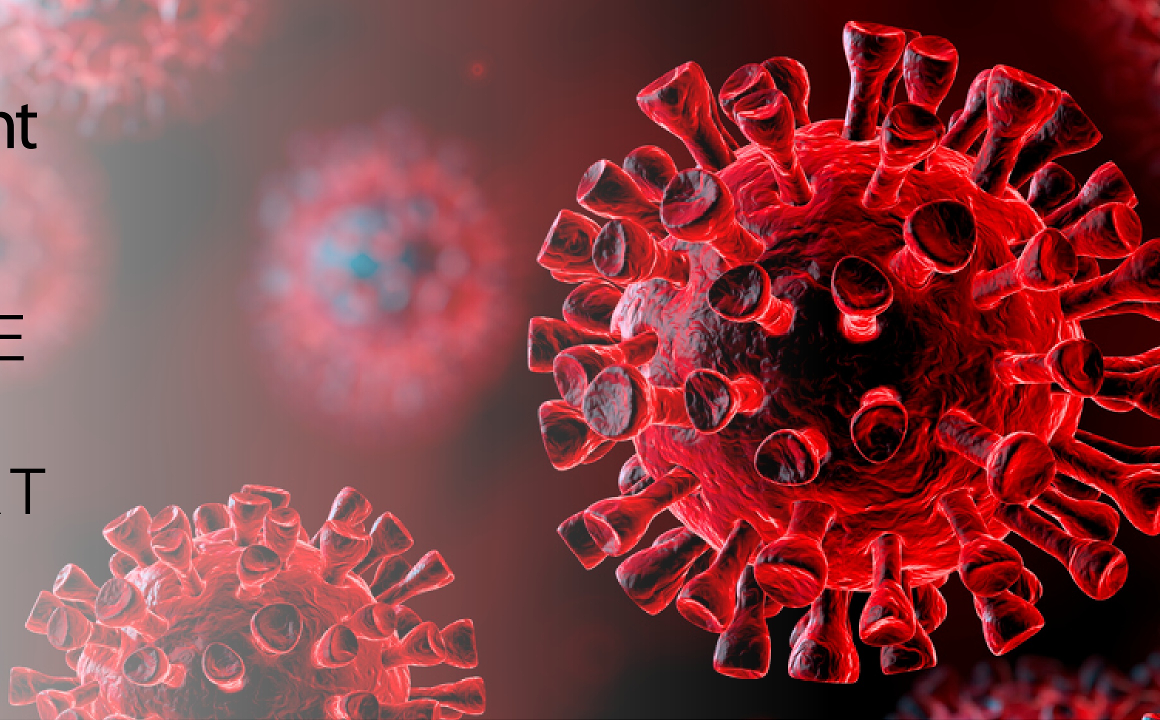
EMPLOYEE BENEFITS LAW ALERT



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GREG DAUGHERTY
614.227.2005
gdaugherty@porterwright.com

DAVE TUMEN
614.227.2260
dtumen@porterwright.com

RICH HELMREICH
614.227.2088
rhelmreich@porterwright.com

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IRC Section 409A v. COVID-19: The nonqualified and executive compensation clash, and how employers can navigate it

Unintended consequences are a fact of life. As one of many examples, after the Titanic sank, the United States enacted a law that required any American ship carrying over 100 tons of weight to have enough lifeboats for every passenger. It was a noble thought - no more rationing of lifeboats in the event of a future ship wreck. Unfortunately, the SS Eastland was a poorly designed ship. The additional lifeboats required by the new law added enough weight to cause the ship to roll over not too far away from shore. Some passengers were able to step on to dry land, but others were trapped as the ship took on water, leading to an unintended tragedy.

We may be seeing a similar (but far less tragic) example of unintended consequences play out in the executive compensation arena. In 2004, Section 409A was added to the Internal Revenue Code to restrict the ability of nonqualified plan participants from canceling their deferral elections and accelerating payment. Section 409A and other corporate reforms also restricted the ability to accelerate stock options and revise incentive plan performance goals and payouts.

Failure to comply with IRC Section 409A results in immediate taxation to the employee of all amounts deferred under the plan (and plans of the same type under aggregation rules) to date, plus an additional 20 percent tax and potential underpayment penalties. Employers also potentially could be penalized for failure to report or withhold taxes properly. The purpose behind these rules was to align the financial interests of the executives who participate in these plans with the long-term success of the employer.

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Yet, when an extraordinary, unforeseen event outside of anyone's control such as COVID-19 comes along, these measures actually could discourage executives and inhibit the ability of the employers to tie pay to performance. Simply stated, Section 409A and other executive compensation measures were designed to fight one problem, but they were never intended to fight the current crisis. What's an employer to do?

This alert will help employers answer that question. Unfortunately, the ability to accelerate payment and cancel elections under nonqualified plans is limited. Employers may, however, have some flexibility in the design of their incentive plan awards for the upcoming performance period, although any changes still may have tax, security reporting and accounting consequences. Employers should consult with their legal and financial advisors before making any changes.

Nonqualified plans

Cancelling deferral elections

Some executives who made elections to defer salary and other compensation for 2020 now may want to revoke those elections in whole or in part. It would be understandable to want more cash this year in a time of uncertainty. Unfortunately, Section 409A generally requires participants to make irrevocable by Dec. 31, 2019, their elections to defer compensation for services performed in 2020.

Early distributions from plans (unforeseeable emergencies)

Section 409A has strict payment timing rules and generally prohibits acceleration of payment. One exception is an unforeseeable emergency. Could COVID-19-related shutdowns of employer businesses qualify as an early distribution event that allows participants to cancel elections and withdraw amounts previously deferred? The regulations under Section 409A provide that an unforeseeable emergency must be a severe financial hardship that results from an illness or accident of the participant (or the participant's spouse, beneficiary or dependent) or other extraordinary and unforeseeable circumstances arising from an event beyond the control of the participant. A shutdown of the employer, by itself, probably is not enough to qualify as an unforeseeable emergency. If it created a situation where a hardship arose, however (e.g., threat of foreclosure on the participant's house), that potentially could be an unforeseeable emergency. Nonqualified plan administrators must be able to demonstrate that the facts supported a determination that an unforeseeable emergency existed. They also must limit the distribution to the amount necessary to satisfy the emergency.

Plan termination

Employers may be considering whether or not to terminate and cash out their nonqualified plans. Again, Code Section 409A has strict rules that limit the ability to terminate plans. First, a plan termination must not occur proximate to a downturn in the financial health of the employer.

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While that is not fully defined, IRS officials have commented in the past that it generally refers to the ability to pay benefits both at the time of termination and when benefits are to be paid. That leads to the next point. When a plan is terminated, distributions typically may not be made until months 13-24 after the termination date. During the first 12 months after the action to terminate the plan, distributions must be made only when they naturally would have occurred (e.g., separation from service). If the goal is to get money in the hands of executives quickly, termination will not work. Finally, an employer may not adopt a similar kind of nonqualified plan until at least three years after the termination date.

Pay cuts and substitutes

Most of the items described previously address ways for the participants in plans to try to access cash. Employers, however, may be tempted to cut salaries so that they can conserve cash. Cutting salary, by itself, should not raise any Section 409A concerns. If an employer wants to substitute the lost salary with something else, however, that could raise potential Section 409A issues. If instead of permanently cutting salary, the employer chose to defer salary unilaterally or replace it with equity grants, those strategies may or may not run afoul of Section 409A, depending on how they are structured.

Incentive Compensation Plans

Annual equity grants

Employers often approve their equity grants in the first quarter of the performance cycle - meaning that COVID-19 struck when many employers either were in the process of establishing their equity grants and already had done so. Employers who have not approved grants yet may want to delay their grants until we have a better idea of how much disruption COVID-19 will cause. They also may want to consider changing performance targets from absolute measures to measures that compare performance to a peer group as well as including a COVID-19 related extraordinary event adjustment. They also may want to consider whether a mix of awards more heavily tilted towards full value awards (such as restricted stock or RSUs) is more appropriate than awards of options or stock appreciation rights. If an employer has already approved the terms of a grant, it may want to consider approving new grant terms that more appropriately tie pay to factors that are within the grantee's control.

Other concerns relate to share usage and pricing. The decline in stock values means that if an employer wants to grant an award equal to a specific dollar amount, it will now take more shares to do that than it would have a few months ago. It is important to make sure that enough shares are reserved under the plan to do that.

Stock option issues

Relatedly, the decline in stock prices creates issues with stock options. Options previously granted may now be underwater. It may be tempting to reprice those options, but repricing can trigger Section 409A violations

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if not handled properly. Most plans also prohibit repricing unless there is shareholder approval. Further, cancelling options and granting new options often is a practice defined as repricing for these purposes. If options have yet to be granted, the issue is that over the long run, the low prices today will result in a windfall to executives. Employers may wish to mitigate that by using a trailing average of prices to set the exercise price. Again, care must be taken when setting an option exercise price to avoid potential Section 409A violations.

Tax withholding issues

When an equity award becomes taxable, the amount of taxable income is equal to the value of the award on the date of the taxable event (vesting, exercise or settlement, depending on the type of award). Many plans allow broker-assisted transactions to sell shares to cover the withholding obligations. These transactions often occur a day or two after the taxable event. In normal times, that often poses no problem. When the market is volatile, however, a sharp decline in the value of stock could mean that many more shares must be sold to pay the withholding tax. As such, withholding from other sources of funds may be a better strategy for a while.

Annual cash-based incentive awards

The issues with annual cash-based incentive awards are similar to those with long-term equity grants. Employers who have yet to approve their awards may want to wait until we have a better grasp how COVID-19 will affect business operations. Employers who already approved award terms may want to adjust or revise those awards.

Prior year awards

If awards were granted in past year but are to be settled in 2020 or later, COVID-19's impact on the market may wreak havoc with the value of those awards and potential payouts. Employers who wish to use discretion to adjust those awards need to consider whether those awards are grandfathered under IRC Section 162(m). In general, Section 162(m) prohibits an employer from claiming a deduction with respect to compensation in excess of $1 million that is paid to covered employees. Prior to tax reform, however, qualified performance-based compensation was not subject to this $1 million deduction limit. The result is that awards granted before November 2, 2017, may still qualify as performance-based compensation and remain deductible. Materially modifying these awards may cause a loss of grandfathered status and deductible. Before adjusting any prior award, it is important to determine whether doing so could cause a loss of a tax deduction.

Plan, accounting and securities issues

As much as possible, employers should remain consistent with past practices. Obviously, that may not always work in the current climate. Before deviating from past practices, employers should consider the

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following three items (in addition to what we previously discussed in this alert):

- Review the plan terms. If the plan does not allow the contemplated changes, it will need to be amended, and the employer will need to know who has authority to approve such changes.
- Consider the securities issues. Changes to a type of award, for example, may require a Form 8-K filing and also may need to be described in the Compensation Discussion and Analysis of the proxy statement.
- Consider the accounting issues. It is important to consider whether any proposed changes could cause significant accounting issues. The last thing a company would want would be to have to record a larger expense than necessary simply because it changed the nature of an award.

Unintended consequences will always abound, but that does not need to stop us from being mindful of the current situation and responding appropriately. With careful planning, employers can navigate the current storm and design a plan that keeps their employees motivated while preserving shareholder value.

For more information please contact Greg Daugherty, Dave Tumen, Rich Helmreich or any member of Porter Wright's Employee Benefits Practice Group.

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