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2020 Deferred Compensation Elections May be “Cancellable” Under New IRS Guidance

While many aspects of Friday’s IRS Notice on CARES Act provisions were anticipated (e.g., the expansion of the list of individuals who can qualify to receive enhanced loans and distributions from their 401(k) plans), there was a nonqualified deferred compensation plan “surprise.”

As a reminder, nonqualified deferred compensation plans regulated by Section 409A of the Internal Revenue Code generally include any compensation that is earned in one year and paid in a future year (with many special exemptions and nuances). Code Section 409A generally requires that any election to defer the payment of the compensation meet certain requirements. For example, an initial election to defer compensation generally meets the Section 409A requirements if the election to defer the compensation is made – and becomes irrevocable – not later than the close of the tax year preceding the year in which the compensation is earned (i.e., the close of the service provider’s tax year next preceding the year in which the services were performed).

An exception to the rule that the deferral election be in place and irrevocable exists where a plan may provide for a cancellation of a service provider’s deferral election (permissible or mandatory) due to an unforeseeable emergency or a hardship distribution (as defined by reference to the 401(k) rules). Friday’s IRS Notice clarifies that if an individual receives a distribution from an eligible retirement plan that constitutes a coronavirus-related distribution (i.e., a tax-advantaged in-service distribution to individuals who meet certain requirements), that distribution will be considered a hardship distribution for purposes of Code Section 409A. Treating a coronavirus-related distribution as a hardship distribution means that a nonqualified deferred compensation plan may provide for a cancellation of the service provider’s deferral election, or such a cancellation may be made, due to a coronavirus-related distribution. The IRS explicitly states

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that the deferral election must be cancelled, not merely postponed or otherwise delayed.

Employers with nonqualified deferred compensation plans that allow for deferrals should review their plan provisions closely as it relates to hardship distributions; decisions will need to be made as to how deferrals for 2020 compensation may be impacted.

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