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Compensation and Benefits Considerations in a Troubled Economy

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An uncertain economic environment raises a variety of questions around employer-provided compensation and benefits, each with varying tax implications. There are a number of key considerations for employers implementing and addressing retention, employee hardship assistance, and reductions in force. In times of financial downturn—whether on an organizational or global scale—employers may also be in search of ways to promote efficiencies and support continued liquidity. These issues and efforts to respond to them may affect qualified defined contribution plans, qualified defined benefit plans, and nonqualified deferred compensation as well as severance pay and employee assistance programs. This article addresses some of the more frequent compensation and benefits tax considerations that can arise during difficult economic times.

Qualified Retirement Plans

Retirement plans that satisfy certain requirements under the Internal Revenue Code[1] are entitled to tax-favored treatment. These "qualified" plans are generally divided into two main categories: (1) defined

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

contribution plans (such as 401(k) plans) and (2) defined benefit plans (including traditional pension plans and cash balance plans). While many complex requirements and restrictions apply broadly to both types of plans, certain considerations are more relevant to one type or the other. Some qualified plan rules and tax consequences that are commonly implicated in times of economic uncertainty are described below.

Partial Terminations

Downsizing may give rise to a partial plan termination of a qualified plan.[2] Section 411(d) provides that, when a qualified employee benefit plan terminates or partially terminates, the rights of all "affected employees" to benefits accrued under the plan through the date of the termination or partial termination must become "nonforfeitable" (i.e., fully vested). The purpose of requiring accelerated vesting upon a full plan termination is to prevent employers from terminating their plans in order to claim reversions at the expense of participants' benefits. The partial termination rule is a backstop to the full termination rule, designed to prevent plan sponsors from evading the consequences (i.e., immediate vesting) of a full plan termination by terminating their plans incrementally.

There are two types of partial terminations: horizontal and vertical. A horizontal partial termination can occur if a defined benefit plan sponsor ceases or reduces future accruals.[3] A vertical partial termination can occur when a defined benefit or defined contribution plan sponsor initiates a permanent reduction of a significant percentage of employees from a plan.

There is little guidance as to what constitutes a vertical partial termination and how to determine when and if a vertical partial termination has occurred. Neither the Code nor ERISA defines "partial termination." Treasury regulations explain that "[w]hether or not a partial termination of a qualified plan occurs (and the time of such event) shall be determined ... with regard to all the facts and circumstances in a particular case."[4]

Courts examining this issue generally hold that a vertical partial termination occurs only when there is a "significant reduction" in plan participants, and they usually reference the "significant percentage" test first developed by the IRS. The significant percentage test is a ratio of terminated plan participants over total plan participants. In Revenue Ruling 2007-43, the IRS's position is that all participants—both vested and non-vested participating employees—are taken into account in calculating the turnover rate.[5]

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[2] These same rules apply to defined benefit plans as well.

[3] *See* section 1.411(d)-2(b).

[4] *See* section 1.411(d)-2(b)(1).

[5] Prior to this revenue ruling, *Weil v. Terson Co. Retirement Plan Administration Committee*, 933 F.2d 106 (2d Cir. 1991), and *Matz v. Household International Tax Reduction Investment Plan*, 388 F.3d 570 (7th Cir. 2004), held that all participants (vested and unvested) are taken into account in determining whether there was a partial termination. The IRS relied on these opinions in reaching its conclusion in Revenue Ruling 2007-43.

Historically, the determinative percentage was unclear. However, in *Matz v. Household International Tax Reduction Investment Plan*,[6] the Seventh Circuit Court of Appeals held that there was a "rebuttable presumption" that a 20 percent reduction in plan participation resulted in a partial termination, while a lower percentage did not. In Revenue Ruling 2007-43, the IRS adopted the *Matz* test, giving plan sponsors the clearest guidance yet as to what percentage levels were likely to result in a partial termination. The IRS repeated, however, that the ultimate decision as to whether a partial termination has occurred will continue to be made based on the "facts and circumstances" of each case. The facts and circumstances determine the applicable period relevant to determine whether there was a partial termination. Generally, the applicable period is the plan year, but a longer period may apply in the case of a series of related severances of employment.

When downsizing results in a participant reduction close to 20 percent, an employer should consider whether there has been a partial termination.

Coverage and Nondiscrimination Testing

Downsizing usually alters an employer's demographics, which may also affect coverage and "nondiscrimination" testing of qualified plans. The Code contains several nondiscrimination testing rules that all qualified plans must satisfy to maintain their tax-favored status. The rules generally test the benefits as a relationship between highly compensated employees ("HCEs," those making $130,000 and above, adjusted for inflation) and nonhighly compensated employees ("NHCEs"). Reducing the number of NHCEs can shift qualified plan testing ratios so that one or more plans of the employer fail testing. This is especially true in a "controlled group" of employers, as each plan's coverage is tested against the total number of NHCEs in the controlled group.

In addition, defined contribution plans occasionally have a last-day rule that limits employer contributions to participants employed on the last day of the plan year. Notwithstanding the last-day rule, for coverage and nondiscrimination testing purposes, any participant with 500 or more hours of service must be taken into account in testing; if these participants receive no contributions because of the plan's last-day rule, testing results will be affected, and the plan may fail testing.

Employers considering a reduction in force may be able to identify potential nondiscrimination testing issues by examining payroll and demographic data, along with qualified plan documents, for all business entities within a controlled or affiliated group of companies.

Qualified Defined Contribution Plans

Safe-Harbor Plan Contributions

401(k) plans generally must satisfy annual nondiscrimination tests known as the actual deferral percentage ("ADP") or actual contribution percentage ("ACP") tests, which limit the contributions made

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[6] *Matz,* 388 F.3d 570.

by HCEs to a set level above those made by NHCEs. Plans can choose to satisfy these nondiscrimination tests without performing them by making either safe-harbor matching contributions or a safe-harbor non-elective contribution.

With a general decline in corporate profits and limited cash flow, many employers have sought to eliminate, reduce, or suspend their safe-harbor plan contributions. Treasury regulations generally permit an employer to reduce or suspend safe-harbor matching contributions mid-year, as well as reduce or suspend safe harbor non-elective contributions for an employer that suffers a “substantial business hardship.” Factors indicating a substantial business hardship include the following:

- The employer is operating at an economic loss.
- There is substantial unemployment or underemployment in the trade or business and in the industry concerned.
- The sales and profits of the industry concerned are depressed or declining.

If the employer is reducing or suspending safe-harbor matching contributions or safe-harbor nonelective contributions, the plan must satisfy the ADP and ACP tests for the entire plan year (not just the remainder of the year after the reduction or suspension), and employees must be given sufficient notice and opportunity to change their deferral and contribution elections before the employer’s contribution is reduced or suspended.

The employer contributions required for the period prior to the plan amendment reducing or suspending contributions will vary according to plan provisions; some provide for pay period matching, while others refer to on-aggregate contributions for the year. In addition, if an employer fails to contribute for the pre-amendment period in a timely manner, the plan can become disqualified and the failure may be a breach of fiduciary duty and a prohibited transaction.

Under the SECURE Act,[7] certain 401(k) plans that satisfy the safe harbor nonelective contribution requirements are no longer required to provide an annual safe harbor notice. Certain plans can be amended to meet the nonelective contribution safe harbor for the plan year (1) at any time before the 30th day before the close of the plan year or (2) at any time before the last day for distributing excess contributions for the plan year, provided that the contribution the employer is required to make for the plan year for each employee is at least four percent of compensation. In addition, these rules do not apply if the plan provided for the matching contribution safe harbor to apply for any part of the year.

Plan Loans

Most 401(k) plans allow participants to borrow against their accounts. Generally, plan loans must be repaid over five years (or longer in the case of a principal residence loan) and are limited to no more than 50 percent of the employee’s account balance (capped at $50,000). Failure to make timely

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[7] The Setting Every Community Up for Retirement Enhancement Act of 2019, Division O, Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94 (Dec. 20, 2019).

payments results in a distribution[8] of the loan balance that may be subject to an additional 10 percent tax if the participant is not at least 59½ years old. However, there may be a "cure" period that ends on the last day of the calendar quarter following the calendar quarter of the late payment. Thus, if an employee with a plan loan terminates and fails to repay the loan within the cure period (assuming there is one), then the remaining loan balance is taxable. It is possible to "roll over" a loan to a new employer, if both plans have the appropriate language and systems in place.

Historically, the IRS has provided relief with respect to loans made to taxpayers who live or work in areas affected by natural disasters.[9] This relief has mostly been in the form of softened procedural requirements in an effort to ease administrative burdens.[10] It is possible that the IRS could take similar action in difficult or uncertain economic times.

Leave of Absence

Employers often place employees on a leave of absence rather than terminate them. Treasury regulations permit participants on an unpaid leave of absence to forgo loan payments for up to one year during a leave of absence without triggering a taxable distribution, as long as the employee must repay the loan by the end of the original term. The requirement for repayment by the end of the original loan term poses practical problems for participants approaching the end of the original loan term when returning to work.

Repayments from Severance Pay

Some companies allow terminated employees to repay plan loans with severance pay that extends beyond the normal cure period. This is generally permissible if (1) the plan permits loan payments from severance pay and (2) HCEs do not disproportionately benefit from severance pay, which would present a discrimination issue.

Hardship Distributions

Generally, a plan may distribute participant 401(k) elective contributions only following a separation from service; however, a plan may provide that a participant can receive an in-service hardship distribution of elective contributions. A 401(k) plan may allow employees to receive a hardship distribution if the distribution is necessary to satisfy an employee's immediate and heavy financial need.[11] During difficult economic times, employers are more likely to see requests from employees for hardship distributions for various expenses, such as for medical needs, education, and housing (to prevent eviction or foreclosure).[12]

8 Whether the distribution is considered "deemed" or "actual" depends on the circumstances.

9 *See, e.g.*, IRS Announcement 2017-13.

10 *Id.*

11 A hardship distribution may be subject to a 10 percent additional income tax as well as a 20 percent mandatory withholding.

12 As described above with respect to qualified plan loans, the IRS has similarly provided relief with respect to hardship distributions taken by victims of natural disasters. *See, e.g.,* IRS Announcement 2017-13.

Most 401(k) plans make hardship distributions available pursuant to an IRS regulatory safe harbor.[13] Compliance with the safe harbor alleviates the need for a plan administrator to make potentially subjective and difficult determinations as to whether a participant has suffered a financial hardship. Under the IRS safe harbor, hardship distributions are available only for certain categories of enumerated expenses and, therefore, not solely because of a reduction of hours or a furlough. In addition, before a participant may receive a hardship distribution, the participant must have taken all other available distributions from the plan (and certain other employer-sponsored plans specified in IRS regulations), including the maximum permissible plan loan. Also, under the safe harbor, a participant who receives a hardship distribution is precluded from making 401(k) elective contributions for six months.

Qualified Defined Benefit Plans

Lump Sum Distributions from Pension Plans

Allowing lump sum distributions during a downsizing may be difficult for pension plans because of the amount of cash leaving the plan. Unfortunately, eliminating the lump sum option is usually prohibited if the benefit is already accrued. The rules enacted under the Pension Protection Act of 2006, however, may restrict lump sum payouts if benefits were less than 80 percent funded as of the beginning of the year. When a decline in interest rates or asset values occur, plans may be required to satisfy distribution restrictions.[14]

The restriction on lump sum distributions, however, does not restrict the plan’s ability to make mandatory cash-outs for a former participant with a small accrued balance. If the plan allows such a distribution, then amounts of $1,000 or less can be distributed directly to the former participant, and amounts between $1,000 and $5,000 can also be rolled into an IRA.

A qualified defined benefit plan must have special limitations on lump sums paid to the top 25 employees. Under these rules, unless the plan will still be at least 110 percent funded after the distribution to a top-25 individual, the individual either cannot take a lump sum or must provide additional security to the plan before taking a lump sum. With a downturn of the economy, many companies are likely to be below 110 percent of funding and may need to take these steps.

Enhanced Pension Benefits (Plans with Surplus Assets)

Paying severance benefits often immediately reduces cash flow. Instead of paying these benefits, some companies amend their pension plans (in particular, plans with surplus assets) to advance accruals or increase benefits that do not require immediate cash outlays. In addition, companies and employees

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[13] Section 1.401(k)-1(d)(3)(ii)(B).

[14] Certain multiemployer plans may be able to elect prior-year funding status under the Worker, Retiree, and Employer Recovery Act of 2008, Pub. L. No. 110-458.

benefit because pension distributions are exempt from FICA tax. However, if the plan is significantly underfunded, then an enhancement of pension benefits in lieu of severance is not permitted.

Withdrawal Liability for Multiemployer Pension Plans

Withdrawal liability is essentially an exit fee requiring employers to pay their share of a plan's costs (future vested benefits) that have not been paid through previous contributions or investment returns. Withdrawal liability applies only to multiemployer defined benefit pension plans; it does not apply to health and welfare plans, annuity plans, or other defined contribution plans. A multiemployer plan receives contributions from more than one employer, usually related to a collective bargaining agreement.

The funding status of a plan is determined each year by the plan's actuary. Unfunded vested benefits arise when the actuarial value of a plan's vested accrued benefits (the promised future benefits participants have earned a right to receive) exceeds the value of the plan's assets. These calculations are influenced by various assumptions (investment rate of return, mortality, contribution hours, etc.) and by the level of benefits promised to participants. For example, if the plan does not meet its investment return assumption, an imbalance may result, and unfunded vested benefits may be created or increase. The lack of investment returns is a common experience in a general economic downturn.

There are two types of multiemployer withdrawals: complete and partial. A complete withdrawal from a pension plan will occur when an employer either (1) permanently ceases to have an obligation to contribute or (2) permanently ceases all covered operations under the plan. A partial withdrawal from a pension plan will occur when there is a (1) 70 percent contribution decline measured over a three-year period; (2) partial cessation of the employer's contributions to the plan under one or more but not all collective bargaining agreements requiring contributions to the plan and the employer continues to perform work in the jurisdiction or transfers the work to another location; or (3) permanent cessation of an obligation to contribute with respect to work performed at one or more but not all facilities, but the employer continues to perform work at the facility of the type for which contributions were previously required.

If a reduction in force involves employees covered by multiemployer plans, employers should consider the potential for withdrawal liability.

Severance from Employment

Incentive Stock Options ("ISOs") and Employee Stock Purchase Plans ("ESPPs")

Options granted under an ISO plan or ESPP limit the ability of employees to exercise those options after termination. Employees must exercise the options within three months (or less, depending upon the plan terms) of termination for the stock to maintain its tax-advantaged treatment. [15] Employees may immediately sell the stock in a disqualifying disposition, but the employer does not have a withholding

[15] ISO exercises are reported on Form 3921 and transfer of ESPP shares are reported on Form 3922.

obligation for either income tax or employment taxes. The employer does have a reporting obligation with respect to the ISO or ESPP disqualifying disposition (and also on sale of an ESPP stock if it had a discount on purchase). The amounts are reported on Form W-2.

Nonqualified Stock Options

Many employer plans require that nonqualified stock options be exercised within a specified period (e.g., 100 days) following termination of employment. An employer can extend the expiration date of the nonqualified stock option, provided the extension does not go beyond the original option terms absent a termination (often, ten years). Section 409A permits such an extension and does not treat it as the grant of a new option.

Further, section 409A does not consider an option extended if the expiration of a stock option is tolled because the holder is not allowed to exercise it because doing so would jeopardize the employer's ability to continue as a going concern. However, the exercise period cannot be longer than 30 days after it would first no longer jeopardize the company to continue as a going concern.

It is important to remember that even after an employee separates from service, an employer still reports an exercise of a stock option by that former employee on a Form W-2, and such an exercise is subject to income and employment tax withholding.

COBRA

The Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA") gives workers and their families who lose their health benefits the right to choose to continue group health benefits provided by an employer group health plan for limited periods of time under certain circumstances such as voluntary or involuntary termination, reduction in hours worked, and other life events. Qualified individuals may be required to pay the entire premium for coverage up to 102 percent of the cost to the plan.

COBRA generally requires that group health plans sponsored by employers with 20 or more employees in the prior year offer employees and their families the opportunity for a temporary extension of health coverage (called continuation coverage) in certain instances when coverage under the plan would otherwise end.

COBRA beneficiaries generally are eligible for group coverage for a maximum of 18 months (29 months for disabled employees) for qualifying events due to employment termination or reduction of hours of work. Certain qualifying events, or a second qualifying event during the initial period of coverage, may permit a beneficiary to receive a maximum of 36 months of coverage.

Flexible Spending Accounts ("FSAs")

Terminated employees' medical bills can still be submitted to FSAs for reimbursement for medical expenses that were incurred prior to termination. Generally, medical expenses incurred after termination cannot be submitted for reimbursement unless the former employee continues to participate in the FSA (i.e., continues to make contributions). Continued participation may be difficult since former employees no longer receive compensation that can be deferred pre-tax. As a result, former employees may want to make additional pre-tax contributions to the plan prior to termination of employment so that expenses incurred after termination will be eligible for reimbursement.

Business Deduction Limits for Covered Employees[16]

For publicly held corporations, section 162(m) limits the corporate deduction for amounts paid to "covered employees" to $1 million per year. The 2017 tax law commonly known as the Tax Cuts and Jobs Act ("TCJA") amended this limitation, significantly expanding its scope and application. As amended, covered employees include the principal executive officer and principal financial officer (and anyone acting in either capacity) at any point during the tax year and the three highest paid executives for the year determined under SEC compensation disclosure rules, without regard to who is actually listed on the summary compensation table. Covered employees also includes anyone who was a covered employee of the corporation or any predecessor for all tax years beginning after 2016. Once an individual is considered a covered employee, they remain a covered employee with respect to that corporation for all future years including following termination of employment. Companies should consider developing a process to monitor and track covered employees year over year, as some officers may fall out of the top three highly compensated or may terminate from employment but retain their covered employee status.

The TCJA includes a grandfathering provision under which compensation paid pursuant to a written binding contract in effect as of November 2, 2017, may follow the pre-TCJA section 162(m) rules, including the more narrow application and generous exceptions. When there is a change in the leadership of a company and executives are terminated, individuals brought in to replace the terminated executives may unexpectedly become subject to section 162(m), which could result in lost deductions to the company. In addition, as amended by the TCJA, section 162(m) applies to payments made to executives even following termination, such as severance, deferred compensation payments, and stock option exercises.

Withholding on Supplemental Wages in Excess of $1 Million

Separation payments are compensation, are reported on Form W-2, and are subject to FICA and federal income tax withholding if paid to former employees. For lump sum severance payments, an employer may, generally, choose to use either regular wage withholding or supplemental wage withholding (currently 22 percent). However, once the aggregate supplemental wages paid to an employee reach $1 million in a calendar year, the employer is required to withhold on supplemental wages at a flat rate using the highest rate of tax (currently 37 percent). Note that this method is only available when income tax was withheld on the employee's regular wages in the current or immediately preceding calendar year, which may not always be the case for payments made following termination.

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[16] Section 162(m)(5), which is not discussed in this article, applies to recipients of Treasury assistance under the Troubled Assets Relief Program ("TARP"), which most taxpayers have paid back.

Further, while lump sum severance is generally considered supplemental wages, salary continuation may be considered regular wage payments.

Supplemental Unemployment Benefits ("SUB")

Generally, severance pay is subject to employment tax, but there is an exception for payments under SUB programs (as defined under Revenue Rulings 56-249 and 90-72) intended to supplement state unemployment benefits. Such payments are not considered wages for FICA purposes.

SUB programs typically provide for payments (commonly referred to as "SUB-Pay") as part of a planned reduction in force or in a temporary layoff. These payments are usually contingent on individuals remaining eligible for state unemployment benefits. In addition, there is no vested interest in amounts the employer pays into the plan or fund. Employees who leave the company voluntarily or who are discharged for misconduct are not eligible for a benefit. Finally, payments must be paid in installments rather than a lump sum.

A SUB program may result in employment tax savings for both the employer and the employee, including FICA tax savings on the separation payments as well as potential federal and state unemployment tax savings for the employer. However, the SUB program will generally have a negative impact on an employer's unemployment reserve as employees are forced to file for state unemployment benefits, and can only retain the SUB treatment while state unemployment benefits are received. In addition, a SUB program is typically subject to significant benefit administration.

Nonqualified Deferred Compensation

Compensation that is promised to an employee in one year but does not actually pay out until a later year is generally considered nonqualified deferred compensation, if unfunded and not under a traditional tax-qualified retirement plan described above. Section 409A of the Code governs nonqualified deferred compensation and places strict requirements around the time and form of distributions, limiting an employee's discretion to receive the funds earlier or later than originally scheduled.

Delayed Payments

Generally, payments of deferred compensation cannot be delayed without violating section 409A. However, a payment of nonqualified deferred compensation can be delayed if the payment would jeopardize the ability of the employer to continue as a going concern, provided that the payment is made promptly after payment is no longer administratively impracticable or will no longer jeopardize the employer as a going concern.

Nonqualified Deferred Compensation Paid upon "Unforeseeable Emergency"

Section 409A allows for distribution on account of an unforeseeable emergency. These distribution rules are more restrictive than the hardship rules for qualified plans. An unforeseeable emergency is a severe financial hardship to the employee, which can result from an illness or accident of the employee or the employee's spouse, dependents, or beneficiaries. It can include the loss of property due to casualty, as well as similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider. Imminent foreclosure of the employee's primary residence may constitute an unforeseeable emergency. However, the payment of college tuition or purchase of a home does not constitute an unforeseeable emergency.

Nonqualified Deferred Compensation Paid to "Specified Employees"

Section 409A prohibits nonqualified deferred compensation to be paid to "specified employees" of public companies due to separation from service until at least six months after the individual becomes entitled to the payment as a result of the separation (although note that "separation from service" is narrowly defined — e.g., an employee who continues in a "consulting" capacity may not be separated yet). A specified employee is any employee who is (1) an officer of the employer with annual compensation greater than $185,000 (indexed for inflation), (2) a five percent owner of the employer, or (3) a one percent owner of the employer with annual compensation greater than $150,000. Severance arrangements that are not exempt from section 409A and that cover specified employees are required to postpone commencement of severance payments for at least six months after termination of service.

However, exceptions to the section 409A deferred compensation rules also apply to amounts paid to specified employees. Thus, the term nonqualified deferred compensation does not include payments satisfying the section 409A short-term deferral rule or separation pay rule. These rules are quite complex, and companies need to consult with benefits advisors before determining whether a benefit can be paid within the first six months after full separation from service.

Companies often want to accelerate and negotiate payments when involuntarily terminating an executive. However, section 409A is generally designed to prohibit early payments, and the section 409A regulations generally deem "substitute" payments as still subject to the 409A rules. As above, companies need to consult with benefits advisors before negotiating.

Separation Pay Exception

An exception to the section 409A rules exists for separation payments made due to (1) involuntary separation from service (including resignation for good reason) or (2) participation in a "window" program. These arrangements do not provide for a deferral of compensation subject to section 409A to the extent the payment does not exceed two times the lesser of (1) annualized compensation for the year prior to the year of separation and (2) $275,000 (indexed for inflation). Payments under these arrangements must be paid by the end of the second year following the year of separation. Companies should consult with benefits advisors before relying on either of these exceptions or entering into related agreements.

Release Agreements

Employers often require terminating employees to execute a release of claims in order to receive payments made in connection with separation (such as severance). In response to various labor law requirements, employees are typically given a specified period in which to consider, execute, and then revoke (or not) a release. Payments that are contingent on signing a release generally begin once the release becomes irrevocable.

As described above, section 409A places restrictions on the timing of deferred compensation payments and limits employee discretion to accelerate or delay those payments. The IRS issued guidance stating that when payment is conditioned an employee action (e.g., signing a release), it may allow the employee impermissible discretion to choose the tax year of payment when the period of time in which they have to consider and sign straddles two years. Payment timing for amounts contingent on a release can be designed not to run afoul of section 409A. In advance of employee terminations, companies should review existing release provisions with their benefits advisors and carefully consider the timing of any deferred compensation payments in relation to required release agreements.

Equity-Based Awards & Stock Valuations

An economic downturn can affect company strategies with respect to existing and future equity-based awards. A dampened stock value may affect a company's business decisions around what type of awards to grant to employees and the timing of those grants. When the financial outlook is uncertain, companies may be more reluctant to make grants of awards that may require a cash outlay in the near future (such as stock appreciation rights or cash-settled restricted stock units). However, granting stock options during such times may be advantageous for employee award recipients. More specifically, stock options granted during an economic downturn may carry lower exercise prices (in light of the depressed fair market value of the company stock at grant) thus allowing for greater potential appreciation when the fair market value of the company stock rebounds in the future.[17] In addition, the vesting or exercise does not typically require employer liquidity when shares are transferred on exercise.

Employers must also consider the valuation of stock. Often, private companies receive an independent third-party valuation of their stock in order to comply with accounting rules as well as certain fair market value tax requirements, such as stock right exemptions from section 409A. Under applicable rules, companies may generally rely on independent valuations for 12 months, provided there was no change in circumstances that would materially affect the stock value. However, in times of financial strain, it may no longer be reasonable—or advantageous—to continue to rely on prior valuations even if prepared within the last year. Companies may want to consider seeking an updated valuation before granting new equity-based awards or before settling or cashing out existing awards. In a rapidly evolving economic environment, it may be difficult to decide when factors have sufficiently settled to commission a new valuation.

When employees hold underwater stock options, employers may consider repricing or extending the terms of the options to provide the opportunity for value without granting completely new awards.

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[17] One of the key requirements for stock options to be exempt from section 409A is that the exercise price may not be lower than the fair market value of the underlying stock on the date of grant.

Employer-Provided Hardship Assistance

During difficult economic times, companies may consider offering assistance to employees in need. This assistance could take various forms, including employer-provided loans or funding of section 501(c)(3) charitable organizations.

Employee Loans

In an effort to provide support to employees in times of need, employers may offer loans to their employees. An employer-provided loan can provide a meaningful benefit to both parties, and the terms and structure of the loan may look very different to fit a unique scenario. For example, an employer may wish to offer a no-interest loan to an employee during a difficult economic time to help combat immediate financial strains.

The manner in which each loan should be treated from a U.S. federal tax perspective depends on the facts and circumstances surrounding the loan and the repayment terms. Specifically, the proper tax treatment depends in large part on whether the benefit is respected as a bona fide loan and whether a market rate of interest is charged. When all or a portion of the benefit is taxable as compensation, the key questions become the timing and amount of income inclusion.

Whether an amount provided as a “loan” satisfies the requirements of a bona fide loan is generally based on the facts and circumstances. In making this determination, there are a number of relevant factors to consider. The factors largely focus on whether there is a reasonable expectation of repayment at the time the loan is entered into.[18] While each factor is important to consider, no factor is determinative.

In general, there are three main types of employee loans: traditional employee loans, below-market loans, and forgivable loans.

1. Traditional Employee Loans

Traditional employee loans generally do not require that an employee recognize compensation at any point. Instead, an employer loans money directly to an employee who has the full intention and obligation to repay the amount of the loan plus associated interest at market rates.

2. Below-Market Loans

It is not uncommon for employers to provide loans to employees at an interest rate that is below market rates or with no interest charged at all. Depending on the surrounding facts and circumstances, the cash provided may still be considered a bona fide loan between the parties for tax purposes. The employer, however, may need to calculate an amount of imputed interest income and report that amount as compensation to the employee, typically on an annual basis. There is a de minimis

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[18] *See, e.g.*, Nix v. Commissioner, T.C. Memo 1982-330 (June 14, 1982); TAM 200040004 (Oct. 6, 2000).

exception for below-market loans when the aggregate outstanding balance of all loans between the employer and employee does not exceed $10,000.[19]

3. Forgivable Loans

Forgivable loans are a tool employers and other service recipients attempt to use in order to provide cash to employees and contractors up front and also incentivize them the service provider to continue the relationship. The goal is often to provide an immediate benefit while spreading the tax liability over several years or delaying it into a future year. Although building in the possibility of cancellation of the debt up front is not necessarily fatal to establishing a bona fide loan, this type of arrangement should be closely scrutinized to determine whether there is an actual intention that the loan be repaid or if the arrangement more accurately represents compensation from the outset.[20] More specifically, if an employee forgivable loan is characterized as a cash advance, the advance payment must generally be included in the employee's taxable compensation.

Employers should consider current policies around the provision of loans to employees, the appropriate tax treatment based on the specific facts and circumstances, and any resulting reporting or withholding obligations. Implementing consistent procedures going forward—such as establishing standardized policies and loan documentation—can help to inform both the employer and employee of their respective obligations and reduce the risk of unanticipated tax consequences.

Assistance through Charitable Organizations

Another potentially tax efficient manner in which employers can provide hardship assistance to employees in troubled economic times is through the funding of related or unrelated section 501(c)(3) charitable organizations. Assuming several requirements are met, payments to employees through the charitable organization will not result in taxable compensation to the recipient employees. Additionally, to the extent that the program is operated as a public charity, additional tax relief may be available. Further, some employers establish a program through which employees can donate pre- or post-tax wages or unused leave time to charities or to their fellow employees.

For further information, see the KPMG report, *TaxNewsFlash* (March 17, 2020) discussing employee assistance opportunities, including assistance through charities and private foundations.

Travel & Expense Reimbursement Policies

When finances are tight, employers may also want to take a fresh look at their travel and expense reimbursement policies. Payment for travel and other expenses incurred by employees can add up to significant costs. By eliminating nonessential travel and restricting the reimbursement of certain types of expenditures, employers may be able to cut costs without reducing the workforce. For example, implementing "spend smart" initiatives may encourage employees to assist in the cost-savings

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[19] Section 7872(c)(3).

[20] *See, e.g.*, Rev. Rul. 73-256, 1973-1 C.B. 56 (as modified by Rev. Rul. 74-540, 1974-2 C.B. 38); PLR 200452027 (Dec. 23, 2004).

endeavors. When reviewing and considering the existing policies and benefits provided to employees, employers should consider how any changes will be communicated to the teams and the potential collateral impact on employee morale and security. In addition, changes to travel or expense reimbursement requirements may affect the income inclusion requirements as well as the deductibility to the company.

Taking the Next Step

When faced with economic uncertainty, employers should proactively consider any business implications, potential future forecasts, and key objectives in light of the current situation. Best practices include forming a cross-functional committee to evaluate these items, including review of existing arrangements and policies, to develop go-forward strategies. When evaluating each next step, it is important to consider the collateral impact and potential associated tax implications. In addition, the impact of these decisions is meaningful with respect to individual employees as well as the overall workforce. Employee and public communications will be key to successful implementation.

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