

# How to Handle NQDC Plan Benefits in a Divestiture

## WRITTEN BY

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### Introduction

When companies sell part of their business, nonqualified deferred compensation (NQDC) plans present business choices shaped by unique legal considerations. In particular, Section 409A of the Internal Revenue Code (IRC), imposes detailed requirements and legal considerations for addressing NQDC plan benefits in transactions.<sup>[1]</sup> This article explores those business choices and legal considerations.

For this article, we will follow a hypothetical transaction involving ParentCo and its two wholly owned operating subsidiaries – EngineeringCo and ManufacturingCo. ParentCo sponsors an NQDC plan that allows eligible employees to defer a portion of their compensation exceeding 401(k) plan limits and receive related matching contributions that cannot be made to the 401(k) plan due to qualified plan limits under the IRC. Certain highly compensated employees of both EngineeringCo and ManufacturingCo participate in the NQDC plan. ParentCo intends to sell ManufacturingCo to an unrelated third-party buyer. ParentCo wants to consider alternatives for addressing the NQDC plan benefits for the ManufacturingCo employees while maintaining the NQDC plan benefits for the continuing EngineeringCo employees. This article reviews the alternatives that ParentCo should consider.

### Section 409A Overview

Before exploring ParentCo's choices, we need to understand at a high level how Section 409A might apply. NQDC plan benefits must comply with the requirements of Section 409A. Those requirements include:

- Fixing the time and form of payments at the time of deferral;
- Limiting the payment events to death, disability, separation from service, a fixed date or schedule, a change in control event, or an unforeseeable emergency (with each of those events other than death as defined by Section 409A); and
- Prohibiting the acceleration or further deferral of NQDC plan benefits, other than in compliance with limited exceptions specified by Section 409A.

Failure to comply with Section 409A, either in operation or form, triggers significant adverse tax consequences primarily for the employee participating in the NQDC plan. In case of a failure, all vested NQDC plan benefits for each participating employee experiencing the failure must be accelerated into the employee's income for the year of failure, with a 20% additional tax and a penalty-interest additional tax depending on how long the amounts were deferred. An aggregation rule results in the failure applying to the plan for which the failure occurred and any other NQDC arrangements of the employer that fall into the same Section 409A plan category (such as elective account balance plans, nonelective account balance plans, nonaccount balance plans, etc.). In this example, there are two

Section 409A plan categories — an elective account balance plan (tracking the elective deferrals) and a nonelective account balance plan (tracking the make-up matching contributions).

For ParentCo's choices related to the hypothetical divestiture of its ManufacturingCo business, we need to consider whether certain Section 409A rules related to a "change in control event" might apply. Section 409A defines a "change in control event," which is used to determine permitted payment events as well as for other Section 409A compliance rules, including a plan termination rule discussed below. A Section 409A "change in control event" includes:

- A change in the ownership of a corporation (generally, when one person or group acquires more than 50% of the total fair market value or voting power of the corporation's stock);
- A change in the effective control of a corporation (such as when a person or group acquires 30% or more of the voting power, or a majority of the incumbent board is replaced in a 12-month period); or
- A change in the ownership of a substantial portion of a corporation's assets (acquisition of assets with a gross fair market value of at least 40% of the total assets).<sup>[2]</sup>

### **Step One: Section 409A Change in Control Payment Event?**

As noted above, an NQDC plan can be designed to require payments upon a change in control event. The first step for ParentCo, then, is to check the NQDC plan document and any related payment election forms to determine if a change in control event is a payment event under the plan.

If so, ParentCo then needs to determine whether the divestiture of its ManufacturingCo business would be a change in control event of ParentCo that would meet the plan's payment event definition.<sup>[3]</sup> ParentCo's hypothetical divestiture is a type of asset sale by ParentCo, even if structured as a sale of ManufacturingCo's stock to a third-party buyer. Therefore, the divestiture qualifies as a change in control event of ParentCo only if ManufacturingCo represents 40% or more of the gross fair market value of all of ParentCo's assets. If it does, then all participants in the NQDC plan (both EngineeringCo and ManufacturingCo employees) who have a change in control payment event for their NQDC plan benefits would need to be paid upon the closing of the divestiture.

If, however, the NQDC plan does not include a change in control payment event, or if the divestiture does not qualify as a change in control payment event of ParentCo, then NQDC plan account balances are not automatically paid out at the closing. ParentCo can then consider other alternatives.

### **Step Two: Section 409A Change in Control-Related Plan Termination?**

As noted above, Section 409A generally prohibits the acceleration of payments under an NQDC plan, meaning that amounts deferred cannot be paid earlier than the time or event specified in the plan, except in limited circumstances. However, Treasury Regulations under Section 409A provide a specific exception that allows a company to terminate and liquidate an NQDC plan in connection with a change in control event, and to accelerate payment of all deferred amounts to participants, provided certain requirements are met.

To take advantage of the exception, the following requirements must be satisfied:

- **Timing of Termination:** The company must take irrevocable action to terminate and liquidate the plan within the

30 days preceding or the 12 months following the change in control event.

- **Scope of Termination:** All NQDC plans of the same type (*i.e.*, that would be aggregated under the Section 409A plan aggregation rules) sponsored by the company immediately after the change in control must be terminated and liquidated for all participants who experienced the change in control. This prevents selective termination for only certain individuals or plans.
- **Payment Timing:** All amounts deferred under the terminated plans must be distributed to affected participants within 12 months of the date the company takes all necessary action to terminate and liquidate the plans.

Because the ManufacturingCo entity is experiencing a change in control event (*i.e.*, a change in more than 50% of its ownership), the termination and liquidation of the NQDC plan can be limited to the ManufacturingCo employees. This should be true even if the divestiture is also a change in control event for ParentCo (*i.e.*, as a sale of substantial assets).<sup>[4]</sup>

The Section 409A rules prohibit the NQDC plan from providing the impacted employees with a direct or indirect election as to whether to accept the accelerated payment. Ideally, the NQDC plan will include clear language providing ParentCo with a unilateral right to terminate and pay out plan benefits as permitted by Section 409A.

From ParentCo's perspective, a termination and payout of NQDC plan benefits for the ManufacturingCo employees can be a simple approach that avoids having to negotiate with the buyer (as described in Step Three below) or dealing with post-closing administrative challenges in paying future benefits to the ManufacturingCo employees (as described in Step Four below). This approach does, however, result in accelerated income recognition for the ManufacturingCo employees, which may not be an ideal tax result for that group of employees depending on the amounts involved.

### **Step Three: NQDC Plan Spin-off?**

ParentCo may prefer not to terminate and cash out the NQDC plan as to the ManufacturingCo employees, or the NQDC plan may not permit that action. A buyer might also prefer that payments not be made immediately to the ManufacturingCo employees, either because an early payment could lead to employee dissatisfaction or make it more difficult to retain the employees. In any of these cases, ParentCo may negotiate with the buyer to have the buyer assume the NQDC plan obligations for the ManufacturingCo employees — what we sometimes refer to as a plan “spin-off.” An agreement to spin-off the ManufacturingCo portion of the NQDC plan can apply whether the sale of ManufacturingCo is structured as a stock sale or asset sale.

Typically, an NQDC plan assumption by buyer will be reflected in the transaction documents and will require buyer to adopt a “mirror” NQDC plan that preserves the payment rules under ParentCo's NQDC plan. Section 409A prohibits the payment rules for the ManufacturingCo employees to be changed by reason of the NQDC plan spin-off. The parties will also need to determine whether the spun-off plan will permit future deferral elections and how the transaction impacts outstanding deferral elections for post-closing compensation.

The buyer will look for offsetting compensation in the transaction at least equal to the amount of the NQDC plan obligations it agrees to assume. Sometimes this offset can be documented as an adjustment to reduce the purchase price. Alternatively, if the NQDC plan obligations are informally funded through a ParentCo rabbi trust, ParentCo can agree to transfer to buyer (or a buyer-established rabbi trust) a portion of the ParentCo rabbi trust assets corresponding to the assumed obligations.

If the NQDC plan is informally funded through corporate-owned life insurance (COLI) policies owned by ParentCo, transferring ownership of a portion of those policies in connection with the NQDC plan spin-off needs to be reviewed closely against the “transfer for value” rules under Section 101. Under Section 101(a)(1), amounts received under a life insurance contract by reason of the death of the insured are generally excluded from gross income. However, Section 101(a)(2) provides that if a life insurance contract (or any interest in it) is transferred for valuable consideration, the exclusion is limited: only the sum of the consideration paid and subsequent premiums paid by the transferee is excluded from income; the rest is taxable as ordinary income. These Section 101 rules, including whether a transfer of COLI could be treated as a “reportable policy sale” under Section 101(a)(3), are detailed and fact specific, and should be reviewed closely if COLI policies are intended to be transferred.

#### **Step Four: Ongoing NQDC Administration for Divested Employees**

More often than not, a buyer may reject the NQDC plan spin-off alternative. In that case, ParentCo will need to be prepared to continue to administer the NQDC plan as to the ManufacturingCo employees after closing. What that administration looks like depends on the structure of the transaction, primarily because Section 409A treats stock sales and asset sales differently in determining whether the ManufacturingCo employees have experienced a Section 409A separation from service.

If the sale of ManufacturingCo is structured as a stock sale, the ManufacturingCo employees will not have a Section 409A separation from service under the NQDC plan until they have a post-closing separation from service with ManufacturingCo. As a result, in case of a stock sale in which ParentCo retains the NQDC plan obligations for the ManufacturingCo employees, ParentCo and buyer will need to coordinate on an ongoing basis after closing so that ParentCo can properly administer the NQDC plan payment rules, whether those payment rules involve scheduled in-service payments or payments triggered by a Section 409A separation from service (whether lump sum or installments). Depending on the parties, this required post-closing ongoing coordination may not be practicable or desirable. However, this alternative does allow the ManufacturingCo employees to benefit from continued deferral. If post-closing coordination will prove too challenging, ParentCo should revisit the possibility of terminating and cashing out the NQDC plan for the ManufacturingCo employees as described in Step Two above.

In contrast, Section 409A treats a transfer of employment related to an asset sale as a separation from service.<sup>[5]</sup> As a result, if ManufacturingCo is sold in an asset sale, and assuming the NQDC plan triggers payments upon separation from service, the ManufacturingCo employees will receive their NQDC plan benefits in the normal course following separation from service/closing. The form of payment (*i.e.*, lump sum or installments) will follow the normal NQDC plan rules for a separation from service payment event.

#### **Conclusion**

Treatment of NQDC plan benefits in divestitures requires detailed planning to consider alternatives and business needs. Decisions should be made as part of the negotiation of the transaction agreement and reflected in the final transaction documents. See the attached flow chart summarizing the steps discussed in this article.

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[1] For purposes of this article, all section references are to sections of the IRC, unless otherwise noted.

[2] This definition mirrors the Section 280G definition of “change in control,” although Section 280G includes lower

thresholds for triggering a change in effective control (20% under Section 280G rather than 30% under Section 409A) or change in the ownership of a substantial portion of the corporation's assets (33-1/3% under Section 280G rather than 40% under Section 409A).

[3] Note that even if the divestiture of ManufacturingCo is a change in control from the perspective of the ManufacturingCo entity, an NQDC payment event requires the change in control event to be determined at the ParentCo level. Further, for purposes of this article, we will assume any change in control payment event definition in ParentCo's NQDC plan matches the Section 409A definition. In practice, an NQDC plan may apply a more restrictive definition of change in control event than Section 409A requires, but it cannot define change in control event more broadly than Section 409A allows.

[4] If the divestiture transaction is also a Section 409A change in control event for ParentCo (as a sale of substantial assets), ParentCo could also choose to terminate and liquidate the entire NQDC plan, including as to all EngineeringCo and ManufacturingCo employees.

[5] Section 409A also permits the parties in an asset sale to treat the transaction the same as a stock sale for purposes of determining whether the transferred employees have had a Section 409A separation from service due to the transaction. That determination must be made before the closing (e.g., as part of the transaction agreement).

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