Performance-based compensation deferrals

Participant compensation deferral elections for nonqualified deferred compensation plans must generally be made within 30 days after initial eligibility in the plan,[1] or, for ongoing participation in the plan, before the start of the calendar year in which compensation is earned.[2] Under Internal Revenue Code Section 409A (IRC Section 409A), however, special rules apply for plan participants making deferral elections for "performance-based compensation."[3]

Overview of performance-based compensation

Performance-based compensation criteria. Performance-based compensation is compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of pre-established organizational or individual performance criteria. The pre-established criteria must be documented in writing within 90 days from the commencement of the service period. The service period must be a period of at least 12 months or more and meet the following requirements:[4]

- Compensation is contingent on satisfaction of organizational or individual performance criteria.
- The performance criteria are not certain to be met at the time they are established.
- Subjective performance criteria specific to the plan participant may be used, if an independent party makes the determination whether the subjective criteria have been met.
- An equity-related bonus must be based solely on the value of the company, or the value of the company's stock, after the date of a grant or award. [5]
- The amount of the performance-based compensation must not be "readily ascertainable" at the time the deferral election is made.[6]

Deferral elections. As long as the bonus compensation is earned over a period of at least 12 months, because the bonus is performance-based compensation, the participant can make the election **up to six months before the end of the performance period,** rather than having to make the election in the tax year prior to which it was earned.[7]

In the participant's first year of eligibility, the performance-based compensation deferral must be prorated, so that only amounts earned after becoming eligible can be deferred.[8] The prorated amount is determined by multiplying the compensation by a ratio: the numerator is the number of days remaining in the performance period;[9] the denominator is the total number of days in the performance period.[10]

Example of proration in the first year of eligibility. If the performance earnings period is based on a calendar year and the participant is newly eligible on July 1, the deferral election becomes irrevocable on July 30 (the 211th day of the year) and the prorated amount that's eligible for a deferral election would be 154/365, or 42.19% of the bonus. The eligible amount is then applied to the participant's deferral election.

The performance-based bonus is $50,000 and the participant makes a 30% deferral election. The amount of the bonus to be deferred will be computed by taking the $50,000 multiplied by the deferral election (30% of $50,000 = $15,000) and prorated by 42.19% ($15,000 x 42.19% = $6,328.50). The proration rules apply only to the first year of eligibility for plan participation.

Caution should be used when a bonus is earned in one tax year and paid in the next tax year.[11] A typical example of a performance-based compensation election is an annual bonus earned over a calendar year and paid in March of the following year. As long as the above criteria are satisfied, because it is performance-based compensation, the participant has until June 30 of the calendar year the bonus is earned to make a deferral election (6 months prior to the end of the performance period). The rules for performance-based compensation are particularly useful in longer term compensation agreements, such as a multi-year "long-term incentive plan" arrangement. The six-month rule for making deferral elections gives plan participants much greater flexibility in when they can make deferral elections of performance-based compensation.

Year-end pre-payment of performance-based compensation considerations

As noted above, performance-based compensation, by definition, refers to compensation earned over a minimum of 12 months, and allows the participant to make a deferral election as late as six months before the end of the earnings period.

If performance-based compensation is paid before the 12-month period has been completed, the compensation will no longer meet the definition of performance-based compensation and the participant would not have option to wait until six months before the end of the performance period to make the deferral election.

Plan sponsors should consult local counsel to review the timing of participant elections to determine the proper deferral amount, if any.

1IRC Sec. 409A(a)(4)(B)(ii); Treas. Reg. §1.409A-2(a)(7)(i)
[2] IRC Sec. 409A(a)(4)(B)(i); Treas. Reg. §1.409A-2(a)(3). An exception to this rule is a bonus earned over a fiscal year.
[3] IRC Sec. 409A(a)(4)(B)(iii)
[4] See Treas. Reg. §1.409A-1(e)(1)-(2)
[5] See Treas. Reg. §1.409A-1(e)(3)
[6] Treas. Reg. §1.409A-2(a)(8)
[7] IRC Sec. 409A(a)(4)(B)(iii); Treas. Reg. §1.409A-2(a)(8)
[8] Treas. Reg. §1.409A-2(a)(7)(i)
[9] For example, the number of days from the date of the election to the date when the participant's deferral election becomes irrevocable.
[10] Treas. Reg. §1.409A-2(a)(7)(i)
[11] Plan sponsors must exercise care when calculating deferrals on performance-based compensation, or any compensation (such as an annual bonus) that's earned over one or more calendar periods and is actually paid in the next year following. Often, a participant will have a different deferral election covering the performance-based compensation bonus earnings period than their current year base salary or bonus election. When the compensation is actually paid, the proper deferral election covering the period the bonus is earned should be used to calculate the amount deferred, not the current election period.

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