APPLIED KNOWLEDGE | RESOURCE GUIDE

Deferral timing rules under IRC Section 409A

For nonqualified plans

This resource guide is designed for administrative committees of plan sponsors whose nonqualified deferred compensation plans allow participants to defer their own compensation into the plan (where the employee has the option to either take current income or elect to defer the income to the future). This educational information is designed to help the administrative committee determine the regulatory deadline by which an irrevocable deferral election must be made. It's important to consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.

Careful planning is important when determining the types of compensation that may be deferred, as allowed by the plan. To defer, the participant must make an irrevocable election before the regulatory deadline. Often, once a payment is due, the regulatory deadline to make the deferral election has passed. Generally, a participant must make a deferral election in the calendar year (i.e., tax year of the participant) prior to the beginning of the earnings period. Under Internal Revenue Code (IRC) Section 409A, the earnings period (not the pay date) will drive the determination of the regulatory deadline to make an irrevocable election.[1] However, there are exceptions to the general rule, including:

Fiscal year compensation.[2] For companies that use a fiscal tax year, rather than calendar tax year, the participant has until the last day of the prior fiscal year to make the deferral election for any fiscal year bonus (though other bonuses and compensation types follow the general rule).

Newly eligible.[3] A participant may make an election to defer compensation within the 30-day period after becoming newly eligible to the plan. A participant is "newly eligible" if they're eligible to participate in the plan for the first time, or they become eligible after 24 or more months of ineligibility. The participant may only defer compensation that's earned after the election becomes irrevocable. See the "Additional items to consider" section below for further details.

Performance-based compensation.[4] If the compensation meets the definition of Section 409A performance-based compensation (PBC), an exception to the general rule applies and allows the participant to make the deferral election no later than six months prior to the end of the earnings period. 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. A participant election to defer this performance-based compensation would need to be made by June 30, six months before the end of the earnings period (which is January 1 – December 31). Plan sponsors may use the flow chart below to determine if a bonus meets the definition of performance-based compensation.

Performance-based compensation (PBC) assessment

Is the bonus performance-based compensation?[5] Section 409A dictates whether compensation earned meets the specific definition of PBC. To understand whether a bonus qualifies, follow the flowchart below:

1. Is the measuring earnings period at least 12 consecutive months?

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

2. Is the compensation contingent on the satisfaction of pre-established organizational or individual performance criteria?

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

3. Are criteria subjective? To be subjective, they must be:
   - Bona fide and
   - Related to the performance of the
     - Participant,
     - A group of participants, including the subject participant, or
     - A business unit for which the participant provides services (which may include the entire organization); and
   - Made by an independent party (not participant, participant's family, or anyone under the participant's control)

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

4. Are the criteria in writing?

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

5. Is the writing established no later than 90 days after the earnings period began?

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

6. Is the attainment of pre-established criteria substantially uncertain at the time the criteria are established?
   - Does not include any amount or portion of any amount that will be paid, either regardless of performance or based on a level of performance that's substantially certain to be met at the time the criteria are established?
   - The amount of bonus is not determined merely by reference to the value of the company or its stock?

   If **yes,** continue to next question

   If **no,** compensation does not meet PBC definition

If you answered "**yes**" to all of the questions above, the bonus may be performance-based compensation. If so, the participant has up until six months prior to the end of the earnings period to make the deferral election. You should consult counsel to confirm the criteria are met.

If you answered **"no"** to any of the questions above, compensation does not meet the PBC definition. This means that the participant must make the deferral election following the general deferral rule (or newly eligible or fiscal year rule, if applicable).

Exceptions to the General Timing Rule for deferrals

	Any bonus *not* meeting the definition of fiscal year or PBC (commonly called service bonus)	Newly eligible participant	Fiscal year bonus	Performance-based compensation
Definition	Any bonus that does not meet the definition of performance-based compensation	First time eligible to participate in the plan, or eligible after 24 or more months after not being eligible	Any bonus earned during the company's fiscal year	Any bonus that satisfies the criteria in the flowchart above
Regulatory deadline for deferral	Last day of the tax year (of the participant) prior to the beginning of the earnings period	30 days after being newly eligible to participate	Last day of the fiscal year (of the company) prior to the beginning of the earnings period	Six months prior to the end of the earning period (either tax year or fiscal year)
Earnings period	Any earnings period	Any earnings period after becoming eligible	Company's fiscal year	At least a consecutive 12-month earnings period

For additional information regarding regulatory deadlines for a participant to make deferral elections on various types of compensation, see the "Deferral timing chart" below.

Additional items to consider:

- If it's the participant's first year of eligibility, then a participant's bonus deferral (both performance- and nonperformance-based compensation) must be prorated, so that only amounts earned after the participant becomes eligible can be deferred. The prorated amount is determined by multiplying the compensation by a ratio: the numerator is the number of days remaining in the performance period; the denominator is the total number of days in the performance period. For example, assume the performance earnings period is based on a calendar year, and the participant is newly eligible on July 1. The participant enrolls and the deferral election becomes irrevocable on July 30 (the 211th day of the year). The prorated amount that's eligible for a deferral election would be 154/365, or 42.19% of the bonus. The proration rules apply only to the first year of eligibility for plan participation.
- Most forms of compensation are eligible for deferral. However, compensation that's currently in a plan subject to Section 409A cannot be deferred into a different plan (but it may be eligible for re-deferral).
- Once a deferral election becomes irrevocable, it may be canceled only under limited circumstances. See Applied Knowledge *Deferred Comp Deferral and Distribution Elections.*
- Special rules apply to equity-based compensation and should be reviewed closely with counsel.

You may want to develop a procedure to determine whether a bonus qualifies for a deferral timing exception under Section 409A. The information and sample flowchart in this document are based on Principal's understanding of the relevant statute and/or regulations and is provided for educational purposes only. Neither Principal nor its employees or agents are responsible for the legal or tax aspects of the information provided, nor its appropriateness for your situation. **Consult your tax and/or legal counsel regarding your compensation structure and any legal implications of deferral timing rules.**

Please complete the following for each eligible compensation type. (See example below)

Compensation name	**Beginning of earnings period (MM/DD/YY)**	**Ending of earnings period (MM/DD/YY)**	**Pay date (MM/DD/YY)**	**Does the compensation qualify for an exception to the General Timing Rule?**
Example: ABC Company Annual Bonus	*01/01/2022*	*12/31/2022*	*Generally paid by 03/15 after the end of the earnings period*	*Yes, with the assistance of counsel, we have determined this bonus is PBC.*

Deferral timing chart

A participant must make an irrevocable deferral election by the end of the participant's tax year prior to which the compensation is earned ("General Timing Rule"). However, due to various exceptions to the general rule, some forms of compensation may have a different regulatory deadline.

Note: Information in this chart presumes that a participant's tax year is a calendar year. Also, the chart presumes that the company uses a calendar tax year—unless otherwise outlined.

Base salary, commissions, and other non-bonus compensation

	Type of compensation	Regulatory deadline for deferral election	Example	Notes
General Timing Rule	Base salary	December 31 prior to the year in which compensation is earned	Earned: Jan. 1, 2022 – Dec. 31, 2022 Deferral deadline: Dec. 31, 2021	Section 409A has special requirements regarding the final payroll of the year. See Applied Knowledge *Year-End Payroll 409A Considerations*
	401(k) base salary offset refunds	December 31 prior to the year in which compensation is earned	Earned: Jan. 1, 2022 – Dec. 31, 2022 Deferral deadline: Dec. 31, 2021	The 401(k) refund itself is not deferred; instead, an amount of base salary equal to the refund amount is deferred. See Applied Knowledge *Base Salary Deferral Elections to Offset a 401k Refund*
	Sales commissions	December 31 prior to the year in which compensation is earned	Sale occurs: Jan. 1, 2022 – Dec. 31, 2022 Deferral deadline: Dec. 31, 2021	Sales commissions are considered earned at the time the sale occurs.[6]
	Board fees	December 31 prior to the year in which compensation is earned	Earned: Jan. 1, 2022 – Dec. 31, 2022 Deferral deadline: Dec. 31, 2021	

Bonus

	Type of compensation	Regulatory deadline for deferral election	Example	Notes
General Timing Rule	Bonus with no established earnings period is commonly called a "spot bonus."	December 31 prior to the year in which compensation is earned	Earned: Spot bonus at any time Paid: Oct. 1, 2022 Deferral deadline: Dec. 31, 2021	A spot bonus is generally an unexpected bonus without any pre-established earnings criteria.
General Timing Rule	Any bonus with a predetermined earnings period, but not meeting the definition of performance-based compensation (PBC). Commonly called "service bonus"	December 31 prior to the year in which compensation is earned	Earned: April 1, 2022 – June 30, 2022 Paid: July 15, 2022 Deferral deadline: Dec. 31, 2021	These bonuses may be quarterly, annually, or any other period of time.
General Timing Rule	Multi-year bonus (not PBC or fiscal year bonus)	December 31 prior to the first year in which compensation is earned	Earned: Jan. 1, 2022 – Dec. 31, 2025 Paid: March 15, 2026 Deferral deadline: Dec. 31, 2021	
Exception to General Timing Rule	Fiscal year bonus (not PBC)	Prior to the beginning of the company's fiscal year.	Earned: April 1, 2022 – March 31, 2023 Paid: June 15, 2023 Deferral deadline: March 31, 2022	This presumes the company uses a fiscal, rather than calendar, tax year.
Exception to General Timing Rule	PBC (company using calendar year)	Six months prior to the end of the earnings period	Earned: Jan. 1, 2022 – Dec. 31, 2022 Paid: March 15, 2023 Deferral deadline: June 30, 2022	
Exception to General Timing Rule	PBC (company using fiscal year)	Six months prior to the end of the earnings period	Earned: April 1, 2022 – March 31, 2023 Paid: June 15, 2023 Deferral deadline: Sept. 30, 2022	This presumes the company uses a fiscal, rather than calendar, tax year.
Exception to General Timing Rule	PBC (multi-year earnings period)	Six months prior to the end of the earnings period	Earned: Jan. 1, 2022 – Dec. 31, 2025 Paid: March 15, 2026 Deferral deadline: June 30, 2025	

Newly eligible participant rules

	Type of compensation	Regulatory deadline for deferral election	Example	Notes
Exception to General Timing Rule	Newly eligible participant—base salary	A participant has 30 days to make an election once eligible and may defer only amounts earned after the election becomes irrevocable.	Become eligible: July 1, 2022 Election period: July 1 – July 30, 2022 Election made: July 15, 2022 Election becomes irrevocable: July 30, 2022 Compensation earned *only* after July 30, 2022, can be deferred	Some plans may require that the first deduction to occur is in the first *full* payroll period after the election becomes irrevocable.
	Newly eligible participant—all bonuses	A participant has 30 days to make an election once eligible and may defer only amounts earned after the election becomes irrevocable.	Become eligible: July 1, 2022 Election period: July 1 – July 30, 2022 Election made: July 15, 2022 Election becomes irrevocable: July 30, 2022 Bonus period: Jan. 1 – Dec. 31, 2022 Compensation earned *only* after July 30, 2022, can be deferred Amount of bonus eligible for deferral: 42.19%	Proration of eligible bonus deferral amounts is calculated based on the number of eligible days in the earnings period after eligibility (154 days/365 days) = 42.19%. The eligible amount is then applied to the participant's deferral election. See Applied Knowledge *Performance-based compensation deferrals*

Long-term incentive plan (LTIP) rules

LTIP subject to IRC Section 409A. Compensation from an LTIP subject to Section 409A cannot be deferred. However, payment may be delayed using Section 409A *subsequent deferral election* rules (commonly called "12-month/ 5-year rule" or a "re-deferral").

LTIP *not* subject to IRC Section 409A. Compensation from an LTIP not subject to Section 409A may be deferred subject to the regulatory deadlines outlined above.

Additional items to consider:

- Once a deferral election become irrevocable, it may be cancelled only under limited circumstances. See Applied Knowledge *Deferred Comp Deferral and Distribution Elections*
- Compensation earned while on leave (FMLA, disability, other leave-based pay) is generally not deferrable, unless the plan allows such deferral and the participant has made a timely election (the year prior to the year such compensation is earned).
- For compensation that's non-elective (where the employee does not have the option to take current compensation), participants must make their time and form elections (how and when to be paid) within 30 days after the employer makes the contribution. However, most plan sponsors choose to collect this election during the annual enrollment period.
- Special rules exist for equity-based compensation and should be reviewed closely with counsel.

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[1] IRC Sec. 409A(a)(4)(b)(i)
[2] Treas. Reg. §1.409A-2(a)(6)
[3] IRC Sec. 409A(a)(4)(B)(ii); Treas. Reg. §1.409A-2(a)(7)
[4] IRC Sec. 409A(a)(4)(B)(iii); Treas. Reg. §1.409A-2(a)(8)
[5] IRC Sec. 409A(a)(4)(B)(iii); Treas. Reg. §1.409A-1(e)(1)
[6] Treas. Reg. §1.409A-2(a)(12)(i)