

June 6, 2005

June 30 Deadline for Bonus Deferral Elections Quickly Approaching

Performance-based compensation awards for performance periods ending December 31, 2005 can be deferred under elections made as late as June 30, 2005. As indicated in a previous Management Alert ([click here](#)), near the end of 2004, Congress enacted Internal Revenue Code Section 409A, altering the structure and operation of nonqualified deferred compensation plans effective January 1, 2005. Among other requirements, Section 409A requires that initial elections to defer compensation be made within specified time frames. Bonus plans that pay awards within two-and-a-half months of the end of the year in which the right to the bonus vests are not subject to these Section 409A rules. However, many plans permit employees to elect to further defer payment of awards.

The election to defer compensation that is not performance-based must be made before the close of the taxable year preceding the year in which the compensation is earned; thus, deferral elections for 2006 compensation must be made by December 31, 2005. However, elections to defer performance-based compensation must be made no later than 6 months before the end of the performance measurement period. Therefore, the initial deadline for deferral elections for performance-based calendar year plans is June 30, 2005. For plans that use a performance period based on a fiscal year, the applicable deadline is six months before the end of the fiscal year.

If the plan permits employees to elect the time and method of payment of the deferred compensation, that election must also be made by the six month deadline.

The more lenient six month initial deferral rule applies to both annual bonus and long-term incentive plans, as long as the performance period is at least twelve months. According to legislative history, performance-based compensation must be conditioned upon individual or organizational performance criteria. Compensation that will be paid regardless of performance, or that is based upon a performance level that is substantially certain to be met is not performance-based compensation for purposes of the 6 month rule.

The IRS anticipates issuing further guidance on the definition of performance-based compensation later in 2005, and has also announced that deferral elections can be reversed prior to December 31, 2005, without adverse tax consequences. Administrators of performance-based bonus plans permitting the deferral of awards with performance periods ending December 31, 2005 should ensure that initial deferral elections are made before June 30, 2005 to avoid the noncompliance ramifications of Section 409A which include 20% excise taxes.

If you have any questions concerning elections for deferred compensation arrangements, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.



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