

Use It or Risk Losing It: Make Your Deferral Elections Now

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One important reminder from the COVID-19 pandemic in 2020 is that, in the words of one scientist, “It is difficult to make predictions, especially about the future.” While that proverb has broader implications, it certainly describes deferred compensation in 2021.

Midyear Deferral Elections for Bonuses

Many employers who maintain nonqualified deferred compensation plans have allowed their employees to wait to make deferral elections for their bonuses and other incentive compensation until the middle of the year. This is allowed under an exception from the normal tax rule (Code Section 409A) that deferral elections must be made prior to the beginning of the year in which the compensation will be earned. The exception allows deferral elections for so-called “performance-based compensation” to be made as late as six months before the end of the performance period.

Limitations on the Midyear Bonus Deferral Exception

For many employers, the COVID-19 pandemic revealed significant limitations on the exception that permits midyear deferral elections for certain bonuses.

The exception applies only to “performance-based compensation” as defined in the tax rules. “Performance-based compensation” is compensation that is contingent on satisfying pre-established organizational or individual performance criteria relating to a performance period of at least 12 consecutive months. The performance criteria also must be established in writing no later than 90 days after the beginning of the performance period.

Compensation that meets these requirements may be deferred under a deferral election made up to six months before the end of the performance period (as long as the compensation has not become reasonably ascertainable by that time).

Compensation that does not meet these requirements can generally only be deferred if the deferral election is made prior to the beginning of the year (subject to other exceptions not discussed here).

Deferrals Disrupted by the COVID-19 Pandemic

The COVID-19 pandemic disrupted the usual midyear deferral election process in two ways:

- As a result of the economic uncertainty at the beginning of the year, some companies delayed setting their performance goals for bonuses and other incentive compensation until later than 90 days after the beginning of the year. The delay in setting performance goals means that these bonuses and other incentive compensation failed to qualify as “performance-based compensation,” with the result that the midyear deferral exception was not available.
- In recognition of the unanticipated impact of the pandemic on business performance in 2020, some companies have exercised, or are considering exercising, discretion under their incentive compensation programs to pay bonuses despite missed performance goals. To the extent bonus payouts are increased through the exercise of discretion, the increased payouts may not be considered “performance-based compensation” for purposes of the tax rules on deferred compensation. This means that the midyear deferral exception would not be available for such increased payouts.

Takeaway: Don’t Delay in Making Deferral Elections

The disruptions to the normal deferral election cycle in 2020 caused by the COVID-19 pandemic serve as a reminder that companies cannot count on their bonuses remaining “performance-based compensation,” and eligible for midyear deferral elections in any year. To avoid this type of disruption in the future, companies that want to ensure their employees have an opportunity to elect to defer their bonuses should consider requiring elections for all types of compensation, including bonuses and other incentive compensation, to be made prior to the beginning of the year.

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