Companies Should Consider Early Bonus Payments

Tax Rates Scheduled to Increase on January 1, 2011

For more information regarding the tax implications of paying 2010 bonuses early, please contact your Vorys attorney or:

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On January 1, 2011, the highest federal income tax rate is scheduled to increase from 35% to 39.6% when several temporary tax cuts expire. Congress may act to extend these tax cuts after the November elections, but the Obama administration opposes providing relief for "high earners."

Many companies are considering paying bonuses that normally would be paid in early 2011 by December 31, 2010 to ensure that employees receive the benefit of the current, lower tax rates. However, before making this payment, companies should ensure that early payment does not result in adverse tax consequences under Section 409A of the Internal Revenue Code or result in a loss of deduction under Section 162(m) of the Internal Revenue Code.

Section 409A

Purely discretionary bonuses or incentive compensation that is payable by March 15, 2011 (for companies with fiscal years ending on December 31, 2010) may be paid at any time prior to December 31, 2010 without resulting in adverse tax consequences under Section 409A of the Internal Revenue Code.

If bonuses normally are paid after March 15, 2011 (for companies with fiscal years ending on December 31, 2010), the bonuses are considered to be "deferred compensation" subject to Section 409A. Section 409A requires that deferred compensation be payable at an "objectively determinable and non-discretionary" time and prohibits payment from being made earlier than this time. If early payment is made, Section 409A imposes a 20% additional income tax, plus interest and penalties, on each employee receiving an early payment.

Section 162(m)

Bonuses paid by public companies that are intended to be deductible "performance-based compensation" under Section 162(m) of the Internal Revenue Code are subject to special limitations. These limitations include a requirement that the compensation committee first certify that performance has been achieved before payment can be made.

Normally, a compensation committee's certification will be made in early 2011. However, if all or a portion of the required performance already has been achieved, the compensation committee may certify this level of performance allowing payment (or partial payment) to be made prior to January 1, 2011, while preserving the company's tax deduction.

For example, assume that a company maintains an annual bonus plan based on its net income for the period ending December 31, 2010. The projected payout, based on year-to-date performance and projected performance through December 31, 2010, is expected to be 90% of target. The compensation committee may certify the achievement of performance equal to 75% of target (leaving a significant cushion to protect against an unanticipated decrease in performance for the remainder of the period) allowing partial payment to be made by December 31, 2010. In early 2011, when the actual performance is determined, the compensation committee may make a second “true up” certification allowing the balance of the payment to be made.
