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Contingencies on Employee Bonuses Delay Employer's Tax Deduction According to IRS Chief Counsel Memo

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An employer cannot deduct cash bonuses in the year in which its employees perform the services giving rise to the bonuses, but must wait until the following year when the bonuses are paid, under bonus plans with several fairly typical features, according to a recently released Internal Revenue Service chief counsel memorandum (Number 20134301F), dated Sept. 18, 2013. The memorandum illustrates the types of unresolved contingencies that may remain at the end of the year in which employees work to earn their bonuses and delay the employer's deduction until the following year when the bonuses are paid and the contingencies resolved. Although the IRS memorandum applies only to the taxpayer described in the memorandum, and cannot be used or cited as precedent by others, the memorandum nevertheless provides insight on the IRS's current views on these matters.

Facts

The employer in this case maintains several bonus plans. Bonuses are based on the attainment of various performance targets which are approved by a committee of the employer's board of directors in the first quarter of the fiscal year to which the bonuses relate. Bonus payments require committee approval, which occurs after the end of the applicable fiscal year. Some of the bonus plans take into account an employee's individual performance appraisal, which can increase or decrease the bonus. Such performance appraisals are also completed only after the end of the applicable fiscal year. Some bonus amounts are subject to discretionary adjustments by the committee after the end of the fiscal year. Each of the plans reserves to the employer in plain and direct language the right to unilaterally modify or eliminate the bonuses at any time for any reason or no reason prior to payment.

The bonuses are paid within the first 2½ months of the year following the year to which the bonuses relate. Accordingly, the bonuses are not considered deferred compensation,[1] and the "all events test" determines when the employer deducts the bonuses.

All events test

An accrual method employer's tax deduction for employee bonuses is determined under the "all events test."[2] Under the accrual method of accounting, a liability is incurred, and is generally taken into account for Federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy and (3) economic performance has occurred with respect to the liability.[3] Economic performance generally occurs as the services are provided by the employee.[4] Generally all events have

1. In general, the bonuses would be considered deferred compensation if they are not paid within 2½ months after the end of the year in which the employees perform services giving rise to the bonuses. If bonuses are paid after this 2½ month period, the employer's tax deduction is delayed and can only be taken in the year in which the bonuses are includible in the employees' income. Internal Revenue Code §§ 404(a)(5), 404(d); Temp. Treas. Reg. § 1.404(d)-1T.
2. Internal Revenue Code § 461(h) and Treas. Reg. § 1.461-1(a)(2)(i).
3. Treas. Reg. § 1.461-1(a)(2)(i).
4. Treas. Reg. § 1.461-4(d)(2)(i).

occurred that establish the fact of the liability when (a) the event fixing the liability occurs (e.g., the required performance), or (b) payment is unconditionally due, whichever happens earlier.[5] The liability for an expense is generally fixed by the event that creates the legal liability for the expense. In the absence of legal liability, liability for an expense can be fixed by some other event that creates "an absolute liability" (for example, the employer, through action of its board of directors, might obligate itself to make certain payments to employees). On the other hand, a taxpayer may not deduct an anticipated expense, no matter how certain it is to occur, "based on events that have not occurred by the close of the taxable year."[6]

Summary of application of all events test to bonus arrangements

The IRS holds in the chief counsel memorandum that neither the "fact of the liability" nor the "amount of the liability" prong of the all events test is met where bonuses are subject to any of the following conditions:

Condition:	"All events test" not met any earlier than:
Employer retains unilateral right to modify or eliminate bonuses prior to payment.	Payment of bonuses.
Payment of bonuses is subject to committee approval.	Committee approval of bonuses.
Amounts of bonuses depend on subjective determinations, such as individual employee performance appraisals.	Completion of employee performance appraisals.

Reservation of right to modify or eliminate bonuses

Where an employer reserves the right to unilaterally modify or eliminate bonuses otherwise earned under a bonus plan at any time prior to their payment, the employer in fact has no legal obligation to pay the bonuses, according to the chief counsel memorandum. An employer's legal obligation to pay bonuses under its bonus plan is a question of state law, and the IRS cites a number of court cases from various states to support this position. Accordingly, the memorandum finds that there is no legal liability (or any other event) that fixes the employer's liability to pay the bonuses at year end. In fact, the employer's bonus plans explicitly disavow any obligation to pay the bonuses. Therefore, the IRS concludes that since there is no event to fix the employer's liability prior to payment of the bonuses, the "fact of liability" prong of the all events test is not met until the bonuses are actually paid. Furthermore, the IRS observes, since the bonuses are subject to elimination or modification, the "amount of liability" prong of the all events test is also not met.

Committee approval of bonuses

Under the employer's bonus plans, a committee of the employer's board of directors approves the performance targets during the first quarter of the fiscal year to which the bonuses relate. More importantly, during the first quarter of the following year, the committee approves the bonus computations and the actual payment of the bonuses. In so doing, the committee retains, and in some cases has exercised, discretion to adjust the bonus amounts that are otherwise payable based on objective performance metrics. The IRS observes that these adjustments cannot be treated as mere ministerial acts because they change the manner in which the bonuses are computed and the amounts of the bonuses ultimately paid. Therefore, the IRS concludes, neither the "fact of liability" nor the "amount of liability" prong of the all events test is met any earlier than the date the committee approves the bonuses and their payment.

Individual employee performance appraisals

Under some of the bonus plans an employee's bonus is partially based on the employee's individual performance appraisal, which is not conducted until after the end of the year. Depending on the employee's performance appraisal, the amount of the employee's bonus can be increased or decreased (including to zero). The IRS states that where bonus amounts are dependent in whole or in part on some subjective determination made after year end, such as a performance appraisal, the "fact of liability" and the "amount of liability" prongs of the all events test are not met because such subjective determinations are necessarily one of the events that fixes the fact and amount of the liability.

5. Rev. Rul. 2007-3.

6. *United States v. General Dynamics Corp., 481 U.S. 239 (1987).*

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Event fixing the liability for bonuses can occur at year end even if amount of bonuses is not yet known

Bonuses under the bonus plans are calculated at least in part using formulas that have one or more objective performance metrics, such as profit or gross margin. It may well be the case that at year end the relevant financial amounts are not yet known because the employer's accounting records for the year have not yet been finalized. Consequently, the amounts of bonuses that are based on these metrics would also not be known at year end. The IRS states in the memorandum that in such circumstances, the fact that the amount of the bonuses is unknown at year end should not, in and of itself, prevent the "fact of liability" and "amount of liability" prongs of the all events test from being met because the mechanical calculation of the bonuses is not one of the events that fixes liability. The IRS explains that the fact that the bonus amounts are not yet known does not prevent the all events test from being met so long as all variables on which the bonuses are based are fixed at year end.[7]

"Fact of liability" test can be met where aggregate amount of bonuses, though not individual bonuses, are fixed by year end

The IRS memorandum considers Revenue Ruling 2011-29, which essentially held that the "fact of liability" test can be met where bonuses are fixed in the aggregate for a group of employees, though not as to individual employees, by year end. The facts of the revenue ruling were that the minimum total amount of bonuses payable to the employer's employees as a group was determinable either through (a) an objective formula that was fixed prior to year end, or (b) some other corporate action, such as a resolution of the employer's board of directors, taken before year end. To be eligible for a bonus, an employee had to be employed on the date the bonuses were paid. However, any bonus allocable to an employee who was not employed on the bonus payment date was reallocated among other eligible employees. Thus, the IRS notes, the aggregate minimum amount of bonuses payable to the employees would not be reduced by the departure of an employee before the bonus payment date.

The IRS concludes that Rev. Rul. 2011-29 does not apply to the present case. Not only does the present case not provide for reallocation of any forfeited bonuses, the employer in this case is not obligated to pay any particular amount to any individual employee or to all employees as a group, due to its retained right to modify or eliminate any bonuses.

The IRS also considers *Willoughby Camera Stores v. Comm'r*,[8] which held that where an employer incurs a legal obligation in a taxable year to pay employee bonuses in a certain minimum aggregate amount, the employer can deduct such amount in such taxable year even though the bonuses are not actually paid until the next taxable year and the amount of each individual employee's bonus is not known until such next taxable year. The present case is distinguishable from *Willoughby Camera* in that the employer here, having expressly disclaimed liability for the bonuses, has no legal liability for the bonuses at year end.

Concluding thoughts

For business or HR reasons, an employer may want to retain some discretion to modify or eliminate bonuses even after the end of the year for which the bonuses are payable. As illustrated by the IRS memorandum discussed above, depending on the circumstances, this discretion may delay the point in time when the bonuses are deductible even for an accrual method employer. Employers should consider, among other relevant factors, these tax consequences when devising the terms and conditions of their bonus programs.

7. The IRS cites Rev. Rul. 55-446, *modified by* Rev. Rul. 61-127 (Bonuses are properly accruable and deductible for the taxable year to which they relate even though the exact amounts of the bonuses cannot be determined and paid until early in the next taxable year if the employer has definitely obligated itself to a formula as of the end of the taxable year under which the total bonuses are definitely determinable).

8. 125 F.2d 607 (2d Cir. 1942).

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Mark Hamilton *counsels clients on employee benefits and compensation matters, including those arising in mergers and acquisitions, financing arrangements and other types of corporate transactions. He provides counsel regarding stock-based compensation arrangements, employment agreements, change-in-control agreements and all other executive compensation arrangements. His practice includes tax matters, such as Code Section 280G golden parachute issues, performance-based compensation compliance under Code Section 162(m) and the design of deferred compensation plans.*

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