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IRS Requires Come Accrual Basis Employers to Wait to Deduct Bonus Payments Until the Year Paid

POSTED:

Dec 3, 2013

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Accrual-basis employers sometimes retain the discretion not to pay certain bonuses to employees based on performance in one taxable year until early in the next taxable year. Those employers often seek to deduct those bonus payments against their taxable income for the year which was the basis for the bonus. These employers should take note of a recent IRS Chief Counsel Memorandum.[1] In this CCM, the IRS takes the position that an accrual method employer cannot deduct bonuses where the company retains a right to approve the bonuses until the year in which the bonuses are paid.

Background

Employers frequently pay bonuses the year after they are earned and often want to retain discretion over such payments until they are paid. This discretion allows the employer to avoid having to pay bonuses to people who are no longer employed with the company and allows bonuses to be based on individual performance reviews, which may not be completed until the next year. The timing of when to deduct the bonus expense has been a point of contention between employers and the IRS. When to take a bonus deduction is subject to the "all events test."

Specifically, the "all events test" governs the determination of the deductibility of liabilities for an accrual method taxpayer. A deduction may not be taken until each of the following is satisfied:

- All events have occurred that establish liability;
- The amount of liability can be determined with reasonable accuracy; and,
- Economic performance has occurred with respect to the liability.[2]

Recent Chief Counsel Memorandum

In Chief Counsel Memorandum 20134301F, the IRS takes the position that an accrual-basis employer may not deduct bonus payments in the year earned when the employer retains the right to make certain decisions after year end. Such decisions include the ability to modify or eliminate bonuses, to subject the bonus payments to committee approval, or to make the bonuses dependent on a subjective determination, such as a performance review. According to the IRS, prongs 1 and 2 of the all events test are not satisfied when the employer retains the ability to make those decisions after the year end.

The IRS position in the CCM is in stark contrast to the employer-friendly ruling the IRS made two years earlier. In Revenue Ruling 2011-29, which related to the first prong of the all events test, the IRS found that an accrual-basis employer could deduct the bonuses for a group of employees even though the employer did not know the identity of the bonus recipients or the amount payable to each recipient until after the end of the year because the minimum aggregate liability to which the company was subject was fixed before year end and any amounts that were not paid to a specific employee were reallocated among the remaining employees. Thus, a pool of bonuses is a fixed liability when the minimum amount becomes fixed. By contrast, according to the IRS, if a bonus reverts back to the employer when the employee is no longer employed on the date of payment, the liability is not fixed, and therefore the bonus is not deductible until it is paid.[3]

As support for its position in the CCM, the IRS relied on several cases which held that an employer is not legally required to pay a bonus when the terms of the agreement state the bonus payment is discretionary. The IRS rejected several arguments made by the taxpayer. First, it disagreed with the taxpayer's argument that the terms of its plan fell within Revenue Ruling 2011-29 because unlike the taxpayer in the revenue ruling, the employer here was not obligated to pay an aggregate bonus amount that was fixed at year end. Second, it rejected the argument that the employer's historical practices fixed the obligation at year end. Third, it rejected arguments that the employer would be barred by promissory estoppel from failing to pay the bonuses. Finally, it disagreed with the argument that the employer was merely completing certain ministerial acts after year end.

Action Items and Planning Opportunities

In light of the IRS's position, accrual-basis employers must be careful when drafting and administering bonus plans.[4] Bonus plans should be reviewed to determine if the plans may prevent the employer from deducting bonus payments until the year the bonuses are paid. If the plans contain terms which do not fix liability in the year the bonuses are earned, the employer risks the IRS deferring the deduction until a later year.

Depending on the plan currently in place, to minimize the chances of a dispute with the IRS, employers should consider the following actions this year:

- If the employer wishes to retain the right to revoke or modify individual bonus payments, retain that right only until the end of the year or fix the total liability of the bonus plan (i.e., the sum total of all bonuses) by year end, as described in Revenue Ruling 2011-29.[5]
- If bonus payment decisions are based on subjective performance reviews, the employer should conduct all such reviews before the end of the year or fix the total liability of the bonus plan by year end.
- If bonus payment decisions are based on committee or board approval, the employer should obtain all such approvals before the end of the year or fix the total liability of the bonus plan by year end.
- If bonus payment decisions are based on objective factors, calculate the bonus based on an ascertainable fixed metric such as a percentage of the business profits for the year.
- If the employer can ascertain a minimum payment it will pay an employee, the employer could fix that amount of payment and retain discretion over the other part of the payment. The fixed amount should be deductible in the current year and the amount subject to discretion would be deductible in the next year.
- If the employer desires to impose or retain the requirement that the employee remain employed until the bonus is paid, the employer should fix the total liability of the bonus plan by year end.

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[1] Chief Counsel Memorandum, 20134301F (October 25, 2013). An IRS Chief Counsel Memorandum may not be cited as binding precedent and taxpayers may not generally rely on the rulings. However, these memoranda provide valuable guidance on how the IRS is likely to analyze a particular set of facts.

[2] Treas. Reg. 1.461-1(a)(2)(i).

[3] Priv. Ltr. Rul. 201246029.

[4] Many collateral issues are beyond the scope of this alert, including, the application of these principles to Code section 409A, to Code section 162(m) performance based compensation for publicly traded companies, and the method of accounting questions that might arise as a result of such rulings.

[5] While beyond the scope of this alert, this option may not be available to some taxpayers due to IRS regulations limiting the pooling of bonus payments.