

# Cash bonuses not deductible until year of payment, IRS concludes

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## *In brief*

In recently released Field Attorney Advice (FAA) 20134301F, the IRS concluded that a taxpayer was not entitled to deduct cash bonuses paid to employees until the end of the year in which the bonuses were actually paid. The IRS reasoned that certain provisions of the bonus plan prevented the all-events test from being met until payment actually occurred.

Any taxpayer that offers an incentive compensation plan to its employees and that has not reviewed the terms of the plan to determine whether the liability is fixed at year end should consider whether this guidance raises concerns regarding the proper timing of the deduction for payments made pursuant to the plans.

## *In detail*

### **Facts**

The taxpayer in FAA 20134301F had a large number of bonus plans through which employees may be awarded cash bonuses (the Plans). Under the Plans, employee bonuses are calculated using formulas that are largely driven by metrics at the company, sector, unit, and or individual employee level. Some of the Plans also take into account the employee's individual performance evaluation for the year. Bonuses awarded under the Plans generally are not paid until after the close of the tax year when a committee of the board of directors (the Committee) approves the amount and payment of the bonuses. Until the Committee approves the

bonus, the Taxpayer retains the right to modify or eliminate the bonus entirely.

### **Applicable law**

An accrual-method taxpayer generally takes a liability into account for federal income tax purposes in the same tax 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. The all-events test looks only to whether an actual legal right or obligation exists as of the close of the tax year, not the probability that a particular legal right or obligation will occur at some point in the future.

### **IRS reasoning**

The IRS found that a liability is neither fixed nor determinable when the taxpayer retains the right to modify or eliminate the bonus after the close of the tax year. The IRS recognized that in some cases the all-events test has been held to have been met absent an actual legal liability; however, in those cases, the court found another event that fixed that taxpayer's liability -- the payment itself, board action, etc. Such an event, in the IRS's opinion, was not present here.

**Observation:** The provision highlighted in the FAA is a common feature in many bonus plans and may raise questions as to whether a bonus payable pursuant to a plan containing such a provision can be considered fixed at year end.

However, the implication in the FAA is that a taxpayer can have a fixed liability if appropriate action is taken by year end to create a legal obligation to make payment.

The IRS also noted that the taxpayer's liability was neither fixed nor determinable as long as the bonus payments were dependent on subjective employee performance appraisals and also were dependent upon committee approval.

**Observation:** Although there are a number of judicial authorities that address the impact of committee approval on the deductibility of bonuses, this is the first time the IRS has suggested that a bonus based on employee performance appraisals that occur after the end of the tax year would not be considered fixed at year end.

The IRS considered the taxpayer's argument -- based on the conclusion reached by the IRS in Rev. Rul. 2011-29 -- that to be deductible, bonuses need only be fixed in the aggregate by year-end, not as to each individual recipient. The IRS concluded that while that argument is correct, it does not apply to the taxpayer in the FAA.

In Rev. Rul. 2011-29, if one employee did not receive a bonus, or got a lesser bonus -- due to not being employed by

the taxpayer on the payment date, or for some other reason -- the amount not paid was reallocated to other employees. In the FAA, amounts not paid to a particular employee are not reallocated to other employees. "More importantly, because it retains the right to modify or eliminate the bonuses, not only is the Taxpayer not obligated to pay any particular amount to any individual employee, *it is not obligated to pay any particular amount to its employees as a group.* Thus, unlike the taxpayer in Rev. Rul. 2011-29, the Taxpayer here has no fixed liability at yearend" (emphasis in FAA).

Similar to the taxpayer in the FAA, the taxpayer in CCA 201246029 (not mentioned in the FAA) attempted to bring itself within the rule set forth in Rev. Rul. 2011-29. In the CCA, each employee must be employed on the payment date to receive a bonus but -- in a similar distinction from the taxpayer in Rev. Rul. 2011-29 -- bonus amounts not paid because an employee has left the company revert to the taxpayer. Therefore, the IRS concluded that "Taxpayer's liability to pay bonuses is not a fixed liability in the year of the related service. Rather, the liability becomes fixed only if the contingency is satisfied -- that is, when the employee is still employed on the date of payment and receives

the bonus compensation. There is no *de minimis* exception to this rule."

### ***The takeaway***

This FAA is the most recent chapter in the series of non-precedential guidance that the IRS has published in the last few years addressing the deductibility of incentive compensation. In light of such guidance, taxpayers already may have reviewed their bonus plans and taken action (if needed) to fix the liability at year end. However, taxpayers that have not reviewed their existing plans, or may have implemented new plans, may wish to consider some or all of the following as a result of the recent FAA:

- Reviewing the terms of incentive compensation plans to determine whether the liability is fixed at year end;
- To the extent that the liability is not fixed under the terms of the plans, determining whether there is some other action that could be taken to fix the liability at year end; and
- Considering whether filing a Form 3115, *Application for Change in Method of Accounting*, may be beneficial.

### ***Let's talk***

For a deeper discussion of how this might affect your business, please contact:

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