



Bonus Time! A Discussion of the Timing of Bonus Deductions

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Companies often deduct their annual bonus expense the year prior to paying the bonus. But should they? The answer is not clear, and the IRS has changed its position on this issue.

This article addresses whether a company can deduct an annual bonus for tax purposes in the year it is earned, rather than the subsequent year in which it is paid. Companies prefer to deduct the bonus in the year it is earned to take advantage of the tax deduction a year earlier and also to allow the annual bonus to be deducted on the tax return in the same year it is accrued for accounting purposes.

In general, companies are entitled to deduct compensation paid to employees in the year in which compensation is required to be recognized as income on the employees' tax return. However, there is an exception to this rule for accrual-method taxpayers: Accrual-method taxpayers can deduct the annual bonus amount in the year earned, if the bonus is (i) paid within two and a half months after year-end and (ii) the all-events test is satisfied.

The All-Events Test

The all-events test is the requirement that all the events fixing an accrual-method taxpayer's right to receive income or incur expense must occur before the taxpayer can report an item of income or expense. In determining an accrual-method taxpayer's right to a deduction, the all-events test is satisfied when:

- All the events have occurred that establish the "fact of the liability";
- The "amount of the liability" can be determined with reasonable accuracy; and
- "Economic performance" has occurred for the liability.

A bonus will not satisfy the requirements of the all-events test in the following situations:

- If an employee must be employed at the time bonuses are paid;
- If forfeited amounts in bonus pool arrangements revert back to the employer; and
- If discretionary bonuses are not determined until the subsequent year.

The IRS has historically taken the position that the all-events test is satisfied and the bonus deduction can be accelerated when an accrual-method taxpayer pays a bonus no later than two and a half months after year-end, the amount of the bonus is fixed prior to year-end (either through a resolution or a formulaic method) and the executive receives the bonus even if not employed on the date the bonus is paid.

Legislative Background

Prior to 2011, there were significant differences between judicial decisions and the IRS position regarding satisfaction of the all-

events test. In *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), the United States Court of Claims held that a liability to pay bonuses was incurred for dealers as a group, even though the ultimate recipients, individual payout amounts and time of payments was indeterminable. The IRS later announced in Revenue Ruling 76-345, 1976-1 CB 134, that it would not follow *Washington Post*, reasoning that if the bonus amount for each individual in the bonus pool was not fixed by year-end even though the total bonus amount for the pool was fixed by year-end, this was still insufficient to satisfy the all-events test. However, the IRS changed its position in Revenue Ruling 2011-29.

Recent IRS Ruling

In November 2011, the IRS released Revenue Ruling 2011-29, which clarified that the facts of the liability can be determined in situations where the minimum amount of bonuses payable is determinable as of the year-end, even if the amount owed to each individual bonus plan participant is unknown. The bonus plan addressed in Revenue Ruling 2011-29 had the following provisions:

- To be eligible for a bonus, an employee must perform services during the taxable year and be employed on the date that the company pays bonuses;
- The bonuses are paid after the end of the tax year to which they relate but before two and a half months after the close of the tax year;
- The minimum total amount of bonuses payable to the company's employees as a group is determinable through a formula that is fixed prior to the end of the taxable year, or other corporate action (e.g., board of director's resolution) is made prior to the end of the taxable year; and
- Any bonus amount allocable to an employee who is not employed on the date on which the company pays bonuses is reallocated among other eligible employees.

The IRS concluded that, because the taxpayer is obligated under the program to pay to the group the minimum amount of bonuses determined by the end of tax year, and because any bonus allocable to an employee who is not eligible for the bonus on the payment date is reallocated to other eligible employees, the fact of the taxpayer's liability for the minimum amount of bonuses is established by the end of the year in which the services are rendered.

Revenue Ruling 2011-29 provides clarification only for the first prong of the all-events test and does not expand on the IRS's position for the other two prongs: that the amount of liability can be determined with reasonable accuracy and that economic performance has occurred for the liability.

Impact on Bonus Arrangements Subject to Internal Revenue Code (IRC) Section 162(m)

As an overview, IRC Section 162(m) generally limits the deduction for compensation paid to an executive of a publicly traded company to \$1 million annually. Companies subject to the IRC Section 162(m) limitation commonly incorporate "negative discretion" in their bonus plans. This often means that the compensation committee retains the right to reduce bonus payments below the amount fixed at year-end. Additionally, some companies reserve the right to apply negative discretion to the size of the bonus pool and return the excess bonus amounts to the employer. We have concerns that the IRS may conclude that these types of arrangements do not satisfy the "amount of the liability" requirement of the all-events test and, therefore, may prevent a company from taking a bonus deduction in the year in which services are rendered.

Remedial Action

A change in a taxpayer's treatment of bonuses to conform with Revenue Ruling 2011-29 will represent a change in accounting method that must be made in accordance with IRC Section 446 and 481, the Regulations thereunder and applicable administrative procedures.

Alvarez & Marsal Taxand Says:

You can eliminate all doubt as to the timing of your company's bonus deduction by accelerating the bonus payout into 2012. This option is especially advantageous this year as current tax rates are set to expire at the end of 2012, and the tax rates in 2013 are expected to be considerably higher. Consideration should be given to paying 2012 bonuses prior to December 31, 2012 so employees can take advantage of the 2012 tax rates.

If your company would still like to pay bonuses in the year following the year they are earned, please keep the following in mind:

- Prior to finalizing the 2011 tax return, take a look at your company's 2011 bonus plan to ensure the annual bonus is deducted in the correct tax year.
- This may be a good time to evaluate your company's 2012 bonus plan and make changes, if necessary, to ensure the 2012

annual bonus satisfies the requirements to be deducted on the 2012 tax return.

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