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Deduction for Bonus Compensation Expense: LAFA Memorandum #20134301F

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The IRS, in its 'Legal Advice issued by Field Attorneys' (LAFA) memorandum number 20134301F dated October 25, 2013, provided guidance with respect to timing of claiming a deduction for bonus compensation paid/payable by an accrual-basis taxpayer. The memo specifically addresses the below three issues with regard to the deductibility of bonus compensation expense:

1. Do amounts paid under the terms of the taxpayer's cash bonus plans, which provide that the **taxpayer retains the unilateral right to modify or eliminate the bonuses at any time prior to payment**, meet the all events test any earlier than the date the amounts are paid?
2. Do amounts paid under the terms of the taxpayer's plans, where amounts must be **approved by a committee of the taxpayer's board of directors before being paid;** meet the all events test any earlier than the date the amounts are approved?
3. Do amounts paid under the terms of certain of the taxpayer's plans, **the computation of which are dependent, in part, on subjective employee performance appraisals,** meet the all events test any earlier than the date the employee performance appraisals are completed?

The facts of the case were as under:

Fiscal year Taxpayer had more than a dozen bonus plans (collectively the Plans) under which employees could be awarded cash bonuses. The performance targets for the Plans were set and approved by the Board of Directors (Committee) during the first quarter of the fiscal year. Under the Plans, employee bonuses were calculated using formulas that were largely driven by the attainment of various metrics at the company, sector, unit, and/or individual employee level.

Taxpayer retained the right to unilaterally modify or eliminate the bonuses at any time prior to payment. Generally, bonuses awarded under the Plans weren't paid until after the Committee approved the bonus plan settlement and payment of the bonuses, which didn't occur until after the end of the fiscal year. Some, but not all, of the Plans took into account the employee's individual performance appraisal for the year.

All of the bonuses at issue were paid after the end of the tax year but no later than the 15th day of the third month following the end of the tax year. The Plans required that an employee be employed at the end of the fiscal year, but didn't require that the employee be employed at the time the bonus was paid.

Analysis:

Under IRC sec. 461(a), a deduction or credit may be taken only for the tax year that is the proper tax year under the taxpayer's method of accounting used to compute its taxable income. In general, reg. § 1.461-1(a)(2)(i) provides that under the accrual method of accounting, a liability is incurred, and is generally taken into account for tax purposes, in the tax year in which: (1) all the events have occurred that establish the fact of the liability; and (2) the amount of the liability can be determined with reasonable accuracy. In addition, economic performance must have occurred with respect to the liability. Generally all events have occurred that establish the fact of the liability when (a) the event fixing the liability, whether that be the required performance or other event, occurs, or (b) payment is unconditionally due. With regard to bonuses paid by accrual-basis employers, an employer may deduct a year-end bonus in the accrual year rather than the actual payment year if the bonus is **paid within the 2 ½ month period following the close of the accrual year and the all events test is met.** (Rev Rul 2007-3, 2007-1 CB 350).

Conclusion:

The IRS concluded on each of three issues as follows-

1. Where the taxpayer retains the unilateral right to modify or eliminate the bonuses at any time prior to payment.

The IRS concluded that where the taxpayer retains the right to eliminate or modify the bonus compensation at any time prior to payment, the bonus compensation expense meets the all events test only on the **date when the bonus compensation is actually paid**. This is due to the fact that the taxpayer in such a case has no legal obligation to pay the bonus amount. Also, the amount of the bonuses could not be determined with reasonable accuracy as long as they are subject to elimination or modification. Thus, neither the fact of liability prong nor the amount of liability prong of the all events test was satisfied as of year-end.

2. Where the amount of bonus is approved by a committee of the taxpayer's board of directors before payment.

Where the amount of bonus compensation is subject to the approval by a committee of the taxpayer's board of directors before payment, the IRS concluded that the all events test was met only when the on **the bonus compensation was actually approved by the committee**. The Committee's approval of the bonus computation and actual payment of the bonuses, which occurred during the first quarter of the following year, was more than a ministerial act (i.e., a procedural or mechanical act that didn't involve the exercise of judgment or discretion and didn't postpone accrual). Approval by the Committee wasn't automatic. The Committee changed the manner in which bonuses were computed and the amount ultimately paid.

3. Where the computation of bonus payment depends, in part, on subjective employee performance appraisals.

The bonus compensation paid meets the all events test only on the **date the employee performance appraisal is completed**, in situations where the computation of bonus payment depends, in part, on subjective employee performance appraisals. Namely, that the all events test wasn't met any earlier than the date the employee's performance appraisal was completed. Where bonus amounts were dependent in whole or part on some subjective determination made after year end (such as a performance appraisal), such subjective determinations are necessarily one of the events that fix the fact and amount of the liability.

Summary of Conclusions:

- Where the taxpayer maintains the unilateral right to modify or eliminate the bonus compensation at any time prior to payment, the expense is deductible to the taxpayer in the year in which the payment is made.
- Where the amount of bonus compensation is subject to approval by a committee of the taxpayer's board of directors, the expense is deductible to the taxpayer in the year in which such approval is received from the committee.
- Where the amount of bonus depends on the performance appraisal of employees, the expense is deductible in the year in which the performance appraisals are completed.

Source: IRS, Thomson Reuters Checkpoint

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