

Tax Advice and Controversy Client Service Group

To: Our Clients and Friends

December 20, 2013

Tips and Traps for Taking Current Year Deductions for Bonus Programs Fixed by End of Year

As the tax year end approaches, careful planning for year-end bonus accruals presents an opportunity to accelerate your deduction - don't accidentally cause deferral. Recent guidance from the Internal Revenue Service provides a roadmap to the latest thinking when claiming deductions for bonus pool accruals. The key take away from Field Attorney Advice Memorandum LAFA 20134301F: scrub compensation committee resolutions approving bonus amounts to remove any possible post-year end discretion to reduce the full bonus pool amount.

Overview

An employer may claim a current deduction for accrued bonuses at year end if the bonuses are paid out within two and half months following year end, even if bonuses have not yet been allocated to specific individuals. In order to claim the current year deduction, the employer must fix the liability before the end of the current year and may not retain any discretion that could reduce the aggregate dollar amount of the bonus program. A properly crafted board or compensation committee resolution is sufficient to fix the amount of the bonus, bind the employer, and permit the employer to claim the current deduction.

Treasury Regulation § 1.461-1(a)(2)(i) provides that accrued expenses of an accrual basis taxpayer that meet the "all events" may be currently deducted. It provides for a three-pronged test to fix the deduction:

- all events must have occurred to establish the fact of a liability;
- the amount of the liability must be determinable with reasonable accuracy; and
- economic performance must have occurred with respect to the liability.

With respect to bonus pools, Revenue Ruling 2011-29 provides that the "all events" test allows a current year deduction for bonus funds an employer is obligated to pay, even where the specific amount each employee will receive has not been determined. So long as the company has a fixed

obligation created by an event during the current year to pay a minimum aggregate bonus pool amount, the employer may claim the deduction in the current taxable year. The current deduction is permitted even if the employer finalizes the individual bonus allocations after the start of the new year.

In the recent field advice cited above, the IRS identified finer points it believes are necessary to satisfy the “all events” test. The employer must be committed to pay no less than the approved bonus pool amount, with no ability to reduce or change the aggregate amounts payable. Any further approvals or modifications to individual award amounts that result in a reduction of the approved bonus pool amount cause the entire bonus pool amount to be considered deductible in the year paid.

The new insight from the IRS is their position that individual allocations from the approved bonus pool amount may be made after the close of the tax year without running afoul of the “all events” tests, but any discretion or application of individual performance standards that results in a reduction of the approved bonus pool amount after the close of the tax year will cause the entire bonus pool amount to fail the “all events” test for the prior tax year.

An employer can, following year end, increase the aggregate amount of bonuses paid without endangering the current year deduction. This may require careful documentation to avoid the appearance of retroactive adjustment to prior year end accruals. Of course, the additional amounts would be deductible in the following year.

An employer looking to capitalize on year-end bonus deductions should carefully plan and structure bonus program approvals and take action through their board of directors or compensation committee to ensure satisfaction of the “all events” test. This dictates becoming comfortable with setting a fixed bonus pool amount which must be paid, even if circumstances like individual performance ratings or achievement of other performance metrics under the program do not end up where anticipated at the time the bonus pool amount is fixed.

For assistance in structuring a program that will allow a current deduction, or simply to discuss this issue further, please speak to your Bryan Cave contact, or to:

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