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## A Guide to Navigating the Treatment of Bonuses Under §409A (Part 3)

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This article (Part 3) focuses on whether under §404 an accrual method employer deducts a bonus in the year in which the employee performs services (Year 1), or in the subsequent year when the employer pays the bonus (Year 2).<sup>1</sup>

Two additional articles (Parts 1 and 2) provide a guide to navigating the rules for favorable tax treatment under §409A. Part 1 deals with cash bonuses. Part 2 focuses on the tax consequences to the employee and employer of a violation of §409A.<sup>2</sup>

### TAX DEDUCTION TIMING UNDER §404

Under §404, when payment of a bonus is deferred to a year after the year in which liability for payment is established, the employer deducts the bonus in the subsequent year that it pays the bonus.<sup>3</sup> An arrangement defers payment of a bonus when the employer pays the bonus more than a brief period after the end of the employer's taxable year in which the employee

performed the services.<sup>4</sup> An arrangement is presumed to defer payment for more than a brief period when the employer pays the bonus after the 15th day of the third calendar month after the end of the employer's taxable year in which the employee performed the services.<sup>5</sup>

Accordingly, when an employer on a calendar taxable year pays a bonus by March 15 of Year 2 for which liability for payment is established in Year 1, the bonus is deductible in Year 1. To establish liability for payment, the employer must satisfy the following three requirements by the close of Year 1:

- (1) all 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.<sup>6</sup>

Generally, all events have occurred that establish the fact of the liability when: (1) the event fixing the liability, whether that be the performance of services or other event, has occurred; or (2) payment is unconditionally due.<sup>7</sup> The liability must be firmly established and not contingent.<sup>8</sup> A taxpayer cannot deduct an anticipated expense regardless of how likely it is to occur "based on events that have not occurred by the close of the taxable year."<sup>9</sup>

The first alternative of the occurrence of the event fixing the liability looks to whether legal rights or ob-

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<sup>1</sup> All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise indicated.

<sup>2</sup> See *A Guide to Navigating the Treatment of Bonuses Under §409A: Part 1*, 46 Comp. Plan. J. 203 (Nov. 2, 2018) and *Part 2*, 46 Comp. Plan. J. 240 (Dec. 7, 2018).

<sup>3</sup> §404(a)(5), §404(b)(1).

<sup>4</sup> Temp. Reg. §1.404(b)-1T, Q&A-2(a).

<sup>5</sup> Temp. Reg. §1.404(b)-1T, Q&A-2(b)(1).

<sup>6</sup> §461(h); Reg. §1.446-1(c)(1)(ii)(A), §1.461-1(a)(2)(i).

<sup>7</sup> Rev. Rul. 2007-3; Rev. Rul. 80-230; Rev. Rul. 79-410, *amplified* by Rev. Rul. 2003-90.

<sup>8</sup> *United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987); *World Airways, Inc. v. Commissioner*, 62 T.C. 786, 802 (1974) (the purpose of requiring that the fact of liability be established "is to protect tax revenues by ensuring that a taxpayer will not take deductions for expenditures that might never occur").

<sup>9</sup> *United States v. General Dynamics Corp.*, 481 U.S. 239, 243-44 (1987); *New York Life Ins. Co. v. United States*, 724 F.3d 256, 263 (2d Cir. 2013) (a liability is not established "by a statis-

ligations have been established as of the close of the taxable year, rather than the probability that the rights or obligations will arise in a subsequent year.<sup>10</sup>

## IRS Guidance on Timing of Deduction

When a bonus arrangement requires that the employee be employed on the date of payment, the liability is contingent on continued employment until that date. The liability does not become fixed until the contingency is satisfied. In CCA 200949040, the Office of IRS Chief Counsel found that all events that establish the fact of the liability did not occur as of the close of the taxable year that the employee performed the services. Accordingly, when the employer pays a bonus within 2½ months after the year in which the employee performed the services, and also requires that the employee be employed on the date of payment, the bonus is deductible only in the subsequent year of payment.

In CCA 200949040, the IRS also addressed the economic performance requirement to establish liability for payment. For liabilities arising from the performance of services, economic performance occurs as the employee performs the services.<sup>11</sup> When the employee must continue employment until the date that the employer pays the bonus, economic performance does not occur until that date. When a bonus is for services performed in Year 1, the employer does not pay the bonus until Year 2, and the employee must be employed on the date of payment in Year 2, economic performance does not occur until Year 2. Accordingly, the bonus is not deductible until Year 2.

In Rev. Rul. 2011-29, a key difference in the bonus arrangement from the one in CCA 200949040 led the IRS to rule that the all events test was satisfied in the year in which the employees performed the services. In Rev. Rul. 2011-29, the aggregate minimum total amount of bonuses payable to the employees as a group was determinable at the end of the year in

which the employees performed the services. It was only this aggregate minimum total amount that was deductible in Year 1.

The deductible amount was determinable through either: (1) a formula that was fixed before the end of the year that used the financial results as of the end of that year; or (2) other corporate action, such as a resolution of the employer's board of directors or compensation committee, made before the end of the year that fixed the amount of the bonuses payable to the employees as a group. However, the identity of the ultimate recipients of the bonus pool and the amount, if any, each employee would receive, was not determinable before the end of the year in which the employees performed the services.

To be eligible for a bonus, an employee had to perform services in Year 1 and be employed on the date that the employer paid the bonuses in Year 2. Any bonus amount allocable to an employee who was not employed on the date on which the employer paid bonuses was reallocated to the other eligible employees. Thus, the aggregate minimum amount of bonuses that the employer paid to the group of eligible employees was not reduced by the departure of an employee after the end of the year in which the employees performed the services and before the employer paid the bonuses in the subsequent year.

The IRS ruled that the requirement that all events have occurred that establish the fact of the liability was satisfied in Year 1. The employer's liability to pay a minimum amount of bonuses to the group of eligible employees was fixed at the end of the year in which the employees performed the services. This was true even though the identity of the ultimate recipients, and the amount, if any, each employee would receive, could not be determined at the end of that year.<sup>12</sup>

Tax counsel should understand that any additional bonus amounts paid above the aggregate minimum total amount in Year 2 are deductible only in Year 2.

An employer that wishes to use Rev. Rul. 2011-29 should set March 1 as the date on which an employee must be employed to receive a bonus. In this manner, the employer will have enough time to reallocate any forfeited bonuses to the other employees by the March 15 payment date, and thereby ensure that the bonuses are deductible in the prior year in which the employees performed the services.

In Rev. Rul. 2011-29, the IRS did not address whether the difference in the bonus arrangement in

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tical probability – however high – that the taxpayer will ultimately pay the expense”).

<sup>10</sup> For cases finding that all events fixing liability occurred by the end of an earlier taxable year, see *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 604 (1986); *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131, 1134 (3d Cir. 1971); *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d 607 (2d Cir. 1942). *Washington Post Co. v. United States*, 405 F.2d 1279, 1283-85 (Ct. Cl. 1969); *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295 (1958), *nonacq.*, 1958-2 C.B. 3, *aff'd*, 266 F.2d 347 (6th Cir. 1961).

For cases finding that all events fixing liability did not occur until the end of a later taxable year, see *United States v. General Dynamics Corp.*, 481 U.S. 239, 243-44 (1987); *Brown v. Helvering*, 291 U.S. 193, 200 (1934); *H.B. Ives Co. v. Commissioner*, 297 F.2d 229, 230 (2d Cir. 1961).

<sup>11</sup> Reg. §1.461-4(d)(2)(i).

<sup>12</sup> See Rev. Rul. 55-446, as modified by Rev. Rul. 61-127 (when bonuses were payable to ascertainable employees under an incentive compensation plan that was communicated to the employees, and the exact amounts of the bonuses were determined under a formula in effect before the end of the taxable year, the bonuses were accruable in that taxable year).

that ruling from the arrangement in CCA 200949040 changed its analysis of the economic performance requirement. Under CCA 200949040, because the employee had to be employed on the date that the employer paid the bonus, economic performance did not occur until the date of payment. However, the economic performance analysis in CCA 200949040 does not apply to the bonus arrangement in Rev. Rul. 2011-29. Once the first alternative of the all events test of the occurrence of the event fixing the liability is satisfied, and §404 otherwise permits the employer to deduct the bonus in Year 1, the economic performance requirement is deemed satisfied.<sup>13</sup>

In CCA 201246029, the employer established a bonus pool and required that employees be employed on the date that the employer paid the bonus. If an employee was not employed on that date, his or her share of the bonus pool was forfeited and reverted back to the employer. The Office of IRS Chief Counsel opined that because it was possible for any portion of the bonus pool to be forfeited and revert back to the employer after the year in which the employees performed services, the entire bonus pool was not deductible until the subsequent year that the employer paid the bonuses.

The latest IRS guidance on the timing of the employer's deduction is IRS FAA 20134301F. The bonus plan required the employees to be employed at the end of the year in which they performed the services, but did not require that they be employed when the employer paid the bonuses in the subsequent year. In addition, the employer reserved the right to modify or eliminate the bonuses at any time for any reason or for no reason. The IRS Office of Chief Counsel opined that the employer's reservation of the right to modify or eliminate the bonuses meant that the employer did not have any legal liability until the date of payment. In addition, the requirement that the amount of liability be determined with reasonable accuracy was not satisfied.

The IRS Office of Chief Counsel also opined that when a compensation committee approved performance targets in the first quarter of Year 1, and had to approve the bonus computations and payment of the bonuses in Year 2, the requirement of approval in Year 2 precluded the all events test from being satisfied in Year 1. For 2009 and 2010, the committee made discretionary adjustments to the computation of certain company-wide metrics. These adjustments changed the way the bonuses were computed and the amounts of the bonuses paid.

The IRS Office of Chief Counsel reasoned that "the fact of liability prong of the all events test is not met

any earlier than the date the Committee approves the bonuses and their payment because no bonus is paid without the Committee's approval and that approval is not automatic. Even more clearly, the amount of liability prong is not met any earlier than the date of Committee approval as the Committee can and does change the amount of the bonuses."

The IRS Office of Chief Counsel acknowledged that the performance of a ministerial act in Year 2 does not prevent the all events test from being met in Year 1.<sup>14</sup> However, the compensation committee's approval was more than a ministerial act. A ministerial act means an act performed without the independent exercise of discretion or judgment.<sup>15</sup> The compensation committee's approval entailed the exercise of discretion and judgment, and the committee's discretionary adjustments to the computation of company-wide metrics changed the amounts of the bonuses paid.

Finally, the IRS Office of Chief Counsel addressed the effect of employee performance appraisals on the all events test. When a plan's bonus formula takes an employee's individual performance score into account in determining the amount of the bonus, and this score is based on an individual performance appraisal conducted in Year 2, the all events test is not satisfied until the date of completion of the performance appraisal. The IRS Office of Chief Counsel opined, "Until the individual performance appraisal is conducted, an employee's bonus amount is not only unknown, it is unknowable because one of the variables needed to calculate the bonus doesn't exist. Thus, neither the fact of liability nor the amount of liability prongs of the all events test are met."

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<sup>14</sup> See *Continental Tire & Rubber Co. v. United States*, 286 U.S. 290 (1932); *Dally v. Commissioner*, 227 F.2d 724 (9th Cir. 1955); *Exxon Mobil Corp. v. Commissioner*, 114 T.C. 293, 314, 319 (2000), *aff'd sub nom., Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996), *cert. denied*, 520 U.S. 1185 (1997).

<sup>15</sup> See *American Snuff Co. v. Commissioner*, 93 F.2d 201, 202 (6th Cir. 1937) (bonuses were computed as a percentage of the company's net profits; once the percentage was fixed before year end, determination of the bonus amounts was a computational matter without any exercise of discretion or judgment; "[T]he fact that the resolution provided that the amounts to be paid should be determined by the treasurer does not affect the question, for the amounts were capable of definite and accurate ascertainment at the time of the completion of the service, at which time the duty to pay such amounts became a legal and binding obligation upon the petitioner"), *cert. denied*, 303 U.S. 662 (1938); *McKenzie Construction Co. v. United States*, 214 F. Supp. 738, 739-40 (W.D. Tex. 1962) (bonuses were to be computed as a percentage of the company's net profits; once the percentage was fixed before year end, determination of the bonus amounts was a computational matter that did not entail the exercise of discretion or judgment; "[T]he computation of the bonuses due for the year 1953 remained uncertain only to the extent that the exact amount of the net profits was unknown (but not unknowable) at the end of the year").

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<sup>13</sup> Reg. §1.461-1(a)(2)(iii)(D).

The IRS Office of Chief Counsel acknowledged that if the amount of a bonus is not known at the end of Year 1, but all the variables to establish the fact of the liability and amount of the liability are fixed at the end of Year 1, the all events test is satisfied at the end of Year 1.<sup>16</sup> For example, this situation occurs when a bonus arrangement uses a formula with one or more objective performance metrics, such as EBITDA. The employer will likely be unable to calculate the bonus at the end of Year 1 because it has not yet closed its books, gathered and reviewed the pertinent information, or completed the necessary computations.

## **TIMING OF DEDUCTION FOR DIFFERENT BONUS POOL ARRANGEMENTS**

Under the IRS guidance, the timing of deductibility of bonuses paid by March 15 of Year 2 under different arrangements is as follows:

(1) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement takes into account individual performance appraisals conducted in the subsequent year, and also requires the employee to be employed on the date of payment in the subsequent year. As long as any forfeited bonuses are reallocated to the remaining employees in the bonus pool, the bonus pool is deductible in the year in which the employees performed services.

(2) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement takes into account individual performance appraisals conducted in the subsequent year, and also requires the employee to be employed at the end of the year in which the employee performed services. In the absence of any reallocation requirement for any forfeited bonuses, the bonus pool is deductible in the subsequent year of payment.

(3) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement grants the compensation committee the discretion to reduce the amount of the bonus pool after that year, and to adjust the performance metrics after that year. The arrangement also requires the employee to be em-

ployed on the date of payment in the subsequent year. The bonus pool is deductible in the subsequent year of payment.

(4) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement grants the compensation committee the discretion to reduce the amount of the bonus pool after that year, and to adjust the performance metrics after that year. The arrangement also requires the employee to be employed at the end of the year in which the employee performed services. The bonus pool is deductible in the subsequent year of payment.

(5) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement grants the compensation committee the discretion to increase the amount of an employee's bonus and the bonus pool after that year, and requires the employee to be employed on the date of payment in the subsequent year. The deductibility of the bonus is bifurcated. The aggregate minimum bonus liability is deductible in the year in which the employees performed services. Any bonus paid in addition to the aggregate minimum bonus liability is deductible in the subsequent year of payment.

(6) The employer sets the amount of a bonus pool by the end of the year in which the employees performed services. The arrangement grants the compensation committee the discretion to increase the amount of an employee's bonus and the bonus pool after that year, and requires the employee to be employed at the end of the year in which the employee performed services. The deductibility of the bonus is bifurcated. The aggregate minimum bonus liability is deductible in the year in which the employees performed services. Any bonus paid in addition to the aggregate minimum bonus liability is deductible in the subsequent year of payment.

(7) An arrangement uses a bonus formula and objective performance metrics measured as of the end of the year in which the employees performed services, requires the employee to be employed on the date of payment in the subsequent year, and does not have a reallocation requirement for any forfeited bonuses. The bonus is deductible in the subsequent year of payment.

(8) An arrangement uses a bonus formula and objective performance metrics measured as of the end of the year in which the employees performed services, and requires the employee to be employed at the end of that year. The bonus is deductible in the year in which the employee performed services. If the arrangement requires board or compensation

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<sup>16</sup> Rev. Rul. 55-446, *modified* by Rev. Rul. 61-127 (when bonus amounts were definitely determinable by a formula in effect at year-end, and the employer was obligated to pay the amounts so determined, the bonuses were deductible in the year in which the employees performed services and not in the subsequent year of payment).

committee approval after that year, and the approval entails more than ministerial acts, the bonus is deductible in the subsequent year of payment.

(9) An arrangement uses a bonus formula and objective performance metrics measured as of the end of the year in which the employees performed services, and grants the board or compensation committee negative discretion to reduce an employee's bonus in the subsequent year. The year in which

the bonus is deductible turns on whether the arrangement reallocates the reductions to the remaining employees. If the arrangement provides for reallocation, the bonus is deductible in the year in which the employees performed services. If the arrangement does not provide for reallocation, the bonus is deductible in the subsequent year of payment.