Office of Chief Counsel
Internal Revenue Service
memorandum

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to:
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subject:
Bonus Accrual

This is in response to your request for our opinion as to whether, under the facts set forth below, (hereafter the "Taxpayer") is entitled to deduct certain cash bonuses it accrued for its taxable years and in the year in which the employees performed the work giving rise to the bonuses or in the subsequent year in which the bonuses were paid. As discussed below, we are of the opinion that the Taxpayer is not entitled to deduct to the bonuses until the year the bonuses were paid. Thus, the bonuses paid for the year are not deductible until the year , and the bonuses paid for the year are not deductible until the year . This memorandum may not be used or cited as precedent.

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ISSUES

1. Do amounts paid under the terms of the Taxpayer's cash bonus plans, which plans 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. (Alternative) Do amounts paid under the terms of the Taxpayer's Plans, which 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. (Alternative) 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.

CONCLUSIONS

1. Neither the fact of liability nor the amount of liability prong of the all events test is met with respect to the bonuses so long as the Taxpayer retains the right to modify or eliminate the bonuses. Accordingly, bonuses paid under the cash bonus plans do not meet the all events test any earlier than the date the bonuses are paid.

2. Neither the fact of liability nor the amount of liability prong of the all events test is met with respect to the bonuses so long as the bonuses are subject to committee approval. Accordingly, bonuses paid under the Plans do not meet the all events test any earlier than the date the bonuses are approved by the Committee.

3. Neither the fact of liability nor the amount of liability prong of the all events test is met so long as subjective determinations need to be made to calculate the amounts of the bonuses. Accordingly, bonuses paid under certain of the Plans do not meet the all events test any earlier than the date the employee performance appraisals are completed.

FACTS

The Taxpayer has a 52/53 week fiscal and taxable year ending on the closest to . The Taxpayer has more than a dozen bonus plans (collectively the "Plans") under which employees may be awarded cash bonuses. One, the Plan (the "B Plan"), covers a large number of sales floor employees. The other Plans (the or " Plans") cover smaller numbers of employees, generally grouped by position and/or business unit. Under the Plans, employee bonuses are calculated using formulas that are largely driven by the attainment of various metrics at the company, sector, unit, and/or individual employee level. The performance targets for the Plans are set and approved by the of the Board of Directors (the "Committee") during the first quarter of the fiscal year. Bonuses awarded under the

Plans are generally[1] not paid until after the Committee approves the bonus plan settlement and payment of the bonuses, which does not occur until after the end of the fiscal year. The Committee approved the fiscal year payments on ,[2] and the fiscal year payments on .[3]

Some, but not all, of the Plans take into account the employee's individual performance appraisal for the year (the B Plan does not take into account the individual employee's performance appraisal). In such cases, the employee's bonus is generally the product of the three factors: the employee's " ," an " ," and an " ." By way of example, if an employee's was $60,000, his was 15%, and his was , his bonus would be $10,440 ($60,000 x .15 x = $). The is the product of the employee's individual performance score and company, sector, and/or unit performance scores. Thus, if the employee's individual score was , his unit score was , and his sector score was , his would be (x x =). An employee's performance score is based on the numerical score from his performance appraisal for the year (*e.g.*, a performance rating of to translates to an individual performance score of). A numerical score below a minimum threshold (*e.g.*,) yields an individual performance score of zero. Thus, if an employee's performance score for the year is below the minimum threshold, the employee will not receive any bonus, irrespective of the company, sector, and/or unit performance scores.[4] The individual performance appraisals are finalized prior to the payment of the bonuses, but *after* the end of the taxable year.

Some of the Plans do not take into account employees' individual performance appraisals. Those plans generally calculate bonuses in a manner similar

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[1] Some Plans provide for quarterly bonuses. Additionally, beginning with the fiscal year , some Plans provide that up to 30 percent of the employee's annual target bonus can be paid based on the mid-year results.

[2] The minutes of the , meeting reflect that the Committee adopted the following resolution: "RESOLVED, that the Committee hereby approves the as described in Exhibit A."

[3] The minutes of the , meeting reflect that the Committee adopted the following resolution: "RESOLVED, that the Committee hereby approves the results of the completed and authorizes the payments, as set forth in Exhibit A attached hereto."

[4] Beginning with the fiscal year , some Plans provide that the individual employee performance component of the bonus is "additive" rather than a component of a single multiplier that determines the entire bonus. In such cases, the employee's performance score only impacts a portion of the bonus (generally percent of the target bonus).

to the plans that take employee performance appraisals into account (*i.e.*, bonuses are the product of factors such as an employee's annual compensation, a multiplier factor, and various performance metrics), but the variable metrics (*e.g.*, revenue, net operating profit, turn rate, etc.) are generally fixed as of the end of the fiscal year, even though they may not be known at yearend because the books have not been closed or the data has not been compiled. However, some of the Plans employ company-wide metrics such as (" ") or (" ") that, while objective in nature, are subject to discretionary adjustments *after* the end of the fiscal year. For example, for , the Committee approved discretionary adjustments to the computation after the close of the fiscal year, and for , the Committee approved discretionary adjustments to the computation after the close of the fiscal year.

Each of the Plans contains the following disclaimer:[5]

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(emphasis added). Except for the B Plan, the Plans all provide that "[" and "

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All of the bonuses in issue are paid after the end of the taxable year but no later than the 15th day of the third month following the end of the taxable year. The Plans require that an employee be employed at the end of the fiscal year, but do not require that the employee be employed at the time the bonus is paid.

LAW

[5] For , the wording of the disclaimer differs slightly in some of the Plans in that it begins "
. . ."

Under an accrual method of accounting, a liability is incurred, and is generally taken into account for Federal income tax purposes, in the taxable 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. Treas. Reg. § 1.461-1(a)(2)(i). See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). Generally all events have occurred that establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, 2007-1 C.B. 350 (citing Rev. Rul. 80-230, 1980-2 C.B. 169, and Rev. Rul. 79-410, 1979-2 C.B. 213). Although an expense may be deductible before it is due and payable, "liability must first be firmly established." United States v. General Dynamics Corp., 481 U.S. 239, 243 (1987). A taxpayer may not deduct an anticipated expense, no matter how certain it is to occur, "based on events that have not occurred by the close of the taxable year." Id. at 243-244.

The fact of liability prong of the all events test looks to whether legal rights or obligations exist as of the close of the taxable year, not the probability that such rights or obligations will arise at some point in the future. Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 34 (1988)("The fact that at the stroke of midnight petitioner knows with absolute certainty, that in the next instant, these rights will arise, cannot compensate for the fact that as of the close of the old year, they do not exist. The all-events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not the probability - or even absolute certainty - that such right or obligation will arise at some point in the future."). See also United States v. Hughes Properties, Inc., 476 U.S. 593, 602 (1986)(liability for progressive jackpot existed at year end "as a matter of state law"); Brassard v. Commissioner, 183 F.3d 909, 911 (8th Cir. 1989)(taxpayer did not incur developer's fee until year in which taxpayer had "legal obligation to pay" fee); Fox v. Commissioner, 874 F.2d 560, 563 (8th Cir. 1989)("[a]ccrual of an expense may not be predicated on the probability that a legal obligation to pay will arise at some point in the future"); H.B. Ives Co. v. Commissioner, 297 F.2d 229, 230 (2nd Cir. 1961)(board approval to purchase annuity contracts for retiring employees did not fix liability where "no underlying legal obligation" arose until following year when taxpayer entered into annuity contracts with annuity provider).

ANALYSIS

Issue 1

The principal question in this case is whether the Taxpayer's reservation of the right to unilaterally modify or eliminate the bonuses prevents the fact of liability and amount of liability prongs of the all events test from being met with respect to amounts paid under the Plans any earlier than the date the bonuses are paid. As discussed below, because the Taxpayer retains, under the terms of the Plans, the right to eliminate or modify the bonuses at any time prior to payment, the Taxpayer has no legal

obligation to pay the bonuses. And because the Taxpayer has no legal obligation to pay the bonuses, and because there is no other event fixing the taxpayer's liability, neither prong of the all events test is satisfied as of yearend.

The Plans reserve to the Taxpayer, in the plainest and most direct language, the right to modify or eliminate the bonuses at any time for any reason or for no reason at all:

Courts have consistently held that where a bonus plan explicitly reserves to the employer the right to modify or eliminate bonuses, the employer has no legal obligation to pay bonuses otherwise earned under the terms of the plan. The following cases, each of which address an employer's legal obligation to pay bonuses under a plan that reserved to the employer the right to modify or eliminate bonuses, are typical:

● Moore v. Illinois Bell Telephone Co., 508 N.E.2d 519, 521 (Ill. App. Ct. 1987), appeal denied, 515 N.E.2d 112 (Ill. 1987). No enforceable contract created where incentive plan provided that the employer "reserves the right to amend, change, or cancel the Incentive Plan at its discretion," that employer "reserves the right to reduce, modify, or withhold awards based on individual performance or management modification," and that "the Plan is a statement of management's intent and is not a contract or assurance of compensation."

● Smalley v. The Dreyfus Corp., 832 N.Y.S 2d 157, 162 (N.Y. App. Div. 2007), rev'd, on other issue, 882 N.E.2d 882 (N.Y. 2008). Employer not liable for breach of contract for failure to pay bonuses where incentive compensation plan provided that management had authority to "modify or annul any individual award, at their sole discretion, with or without notice, at any time," and that "the making, payment and amount of all awards hereunder shall be within the complete discretion of the Corporation acting through its officers."

● Kaplan v. The Capital Company of America, LLC, 747 N.Y.S 2d 504 (N.Y. App. Div. 2002), appeal denied, 790 N.E.2d 275 (N.Y. 2003). Breach of contract claim dismissed where company handbook stated that bonuses were discretionary and that terms of handbook alone governed the employment relationship.

● Spooner v. Reserve Life Insurance Co., 287 P.2d 735. 737 (Wash. 1955). No enforceable contract created where incentive plan provided that: "This renewal bonus is a *voluntary* contribution on the part of the Company. It is agreed by you and by us that it may be withheld, increased, decrease or discontinued, individually or collectively, with or without notice"(emphasis original).

● Automatic Sprinkler Corp. of America v. Anderson, 257 S.E.2d 283, 284 (Ga. 1979). No vested right to incentive compensation where incentive plan provided that "[t]he award of any direct incentive is entirely within the discretion of the corporation and nothing contained herein will be construed to the contrary."

● Sell v. Hertz Corp., 746 F. Supp. 2d 1206, 1212 (C.D. Utah 2010))(applying Utah law). Employer not liable for bonus where employee handbook provided that "this plan does not constitute a binding contract between Hertz Corporation and employees eligible for consideration for a discretionary bonus under the Plan," and "Hertz Corporation reserves the right to modify or suspend, in whole or part, any or all provisions of the Plan."

● Chambers v. The Travelers Companies, Inc., 764 F.Supp. 2d 1071, 1080 (D. Minn. 2011), aff'd 668 F.3d 559 (8th Cir. 2012)(applying Minnesota law). Employer not liable for breach of contract for failure to pay bonus where bonus policy provided that bonuses are "discretionary awards" and are given "at the discretion of management."

● Geras v. International Business Machine Corp., 638 F.3d 1311, 1313 (10th Cir. 2011)(applying Colorado law). Employer not liable for bonus where incentive plan stated "[t]he Plan does not constitute an express or implied contract or a promise by IBM to make any distribution under it" and "IBM reserves the right to adjust the Plan terms, including but not limited to any quotas or target incentives, or to cancel the Plan, for any individual or group of individuals, at any time during the Plan period up until any related payments have been earned under its terms."

● Jensen v. International Business Machine Corp., 454 F.3d 382, 385 (4th Cir. 2011)(applying Virginia law). Employer not liable for bonus where plan stated: "While IBM's intent is to pay employees covered by this program according to its provisions, this program does not constitute a promise by IBM to make any distributions under it. IBM reserves the right to adjust the program terms or to cancel or otherwise modify the program at any time during the program period, or up until actual payment has been made under the program.

The principal reason there is no legal liability for bonuses where a bonus plan reserves to the employer the right to modify or eliminate bonuses is that the disclaimer provision negates any offer by the employer, and without an offer, there can be no contract. As explained in Moore:

> Those three sentences, especially the last one stating '[t]he Plan is a statement of management's intent and is not a contract or assurance of compensation,' make it clear that defendant in the Incentive Plan was promising nothing. Therefore, it would not be reasonable for an employee to believe that defendant had made an offer in the Incentive Plan, and so no enforceable contractual rights were created by that Plan."

Moore, 508 N.E. at 521.[6] See also Jensen, 454 F.3d at 388 ("Jensen fails on the very first requirement [for the formation of a unilateral contract] because the documents on which he relies do not manifest IBM's willingness to extend any offer to enter into a contract. The terms of IBM's Sales Incentive Plan make clear that they are not to be construed as an offer that can be accepted to from a contract."). Additionally, even if a bonus plan with such a disclaimer provision were found to constitute a contract, the employer would still have no legal liability for the bonuses because there could be no breach of contract for failure to pay the bonuses where the contract itself provides that the employer can eliminate the bonuses. Chambers, 764 F.Supp. 2d at 1087 ("even if the Court found that the language of Travelers' bonus policies did not preclude the formation of a unilateral contract, the fact that Travelers' had discretion to determine whether or not to pay Chambers a bonus would preclude a finding of breach of contract").

To satisfy the fact of liability prong of the all events test, some event must have occurred that fixes the taxpayer's liability for the expense. As discussed above, that event generally will be the event that creates legal liability for the expense. Here, however, the Taxpayers' reservation of the right to eliminate or modify the bonuses ensures that the Taxpayer has no legal liability for the bonuses. Likewise, the amount of liability prong of the test is not met because the amount of the bonuses cannot be determined with reasonable accuracy so long as the bonuses are subject to elimination or modification.

There are cases where the fact of liability prong of the all events test has been held to have been met even absent legal liability. But those cases involve some other event that fixes the taxpayer's liability (the payment itself, if nothing else). For example, the fact of liability prong was held to have been met where the court found that the taxpayer *obligated* itself, through board action, to make certain payments to an employee. See Champion Spark Plug Co. v. Commissioner, 30 T.C. 295 (1958), nonacq. 1958-2 C.B. 3, aff'd, per curium, 266 F.2d 347 (6th Cir. 1961)(expense became

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[6] The bonus plan language which the court references is very similar to, albeit not as strong as, that of Plans at issue here. The three sentences in question read as follows:

> AT&T reserves the right to amend, change, or cancel the Incentive Plan at its discretion. It also reserves the right to reduce, modify, or withhold awards based on individual performance or management modification. The Plan is a statement of management's intent and is not a contract or assurance of compensation.

Id. at 520.

"fixed and definite" when board resolution created "unconditional obligation" to make payment to terminally ill employee). However, merely professing an intention to pay an amount is not, without more, sufficient to fix a taxpayer's liability for the amount. H.B. Ives Co. v. Commissioner, 297 F.2d 229 (2nd Cir. 1961). In H.B. Ives Co. the taxpayer's board, desiring to benefit four retiring employees who did not qualify for the company pension plan, passed a resolution in November of 1953 authorizing $22,000 for the purchase of annuity contracts for the four employees. In December of 1953, the taxpayer made an entry in its books debiting pensions paid and crediting accounts payable for $22,000. It was not until January of the following year, however, that the taxpayer actually entered into annuity contracts with the annuity provider. At issue in the case was whether the annuity expense was incurred in 1953 when the taxpayer's board authorized the expenditure, or in 1954, when the annuity contracts were executed. The Second Circuit, reversing the Tax Court, held that the fact of liability had not been established in 1953, stating:

> Thus neither the resolution of the respondent's board of directors, nor the entry on its books, in themselves establish the proper accrual of the claimed liability in 1953. Deduction could be claimed only when the liability to pay became certain. [citations omitted] Yet Ives was under no obligation to pay the insurance company until the contracts were executed in 1954. And while its board may commendably have felt a moral obligation to the four employees, *no underlying legal obligation* similar to that found in Champion Spark Plug [citation omitted] can be said to exist here.

Id. at 230 (emphasis added).

In the present case, the Taxpayer, by the terms of the Plans, explicitly *disavows* any obligation to pay the bonuses. Thus, neither the Plans themselves nor Committee approval of the Plans are events fixing the liability. As there is no other event in this case to fix the Taxpayer's liability, the fact of liability prong is not met until the bonuses are actually paid.

Issue 2

As discussed above, bonuses paid under the Plans are not deductible until the year following the year for which the bonuses are paid because the Taxpayer's right to modify or eliminate the bonuses precludes the all events test from being met until the bonuses are paid. As to bonuses paid under the Plans, there is a second, independent reason the bonuses are not deductible until the following year, namely that the all events test is not met any earlier than the date the bonuses are approved by the Committee.

The performance targets for the Plans are set and approved by the Committee during the first quarter of the fiscal year. Approval of the performance targets, however, does not constitute approval of the bonuses or their payment. That

occurs during the first quarter of the *following* year when the Committee approves the bonus computation and actual payment of the bonuses. This later approval is more than a ministerial act. Given that the Committee has already approved the performance targets at the beginning of the year, there would be no reason for that same body to latter approve the bonus amounts and their payment if that later approval were a mere formality. And, in fact, for both 2009 and 2010, the bonuses as finally approved and authorized by the Committee included discretionary adjustments to the computation of certain company-wide metrics (specifically to the for and to the for). These adjustments cannot be dismissed as ministerial acts as they changed the manner in which bonuses were computed and changed the amount of the bonuses ultimately paid. Thus, as to the Plans, 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.

Issue 3

As to bonuses paid under some of the Plans, specifically those where an employee's individual performance score is a component of the bonus computation, there is yet a third, independent reason the bonuses are not deductible until the year following year for which they are paid, namely that the all events test is not met any earlier than the date the employee's performance appraisal is completed.

Under the Plans, bonuses are calculated using formulas that are driven by one or more metrics, such as net operating profit, turn time, gross margin, etc. In some cases, all of the variables entering into the calculation are fixed at yearend.[7] In others, however, one variable, the employee's individual performance score, is not. Individual performance scores are based on individual performance appraisals, which are not conducted until *after* the end of the year and therefore are not fixed at yearend. The individual performance score is a numerical value that is derived from the numerical

[7] Even if all the variables are fixed at yearend, the actual amount of the bonuses may not be known because the Taxpayer's books haven't yet been closed, the relevant data hasn't yet been compiled, or the computations haven't yet been completed. In such circumstances, the fact that the amount of the bonuses is unknown at yearend should not, in and of itself, prevent the fact of liability and amount of liability prongs of the all events test from being met because the mechanical calculation of the bonuses is not one of the events fixing liability. That the bonus amounts are not yet known does not prevent the all events test from being met *so long as all variables on which the bonuses are based are fixed at yearend*. Rev. Rul. 55-446, 1955-2 C.B. 531, modified by Rev. Rul. 61-127, 1961-2 C.B. 36 (where bonus amounts are "definitely determinable through a formula in effect prior to the end of the taxable year" and where taxpayer has "definitively obligated itself" to pay the amounts so determined, such bonuses are deductible in the year for which they were earned, notwithstanding that they are not paid until following year).

score from the employee's performance appraisal for the year (*e.g.*, a performance rating of to translates to an individual performance score of). In those Plans that take individual performance scores into account, the amount of an employee's bonus generally[8] varies in direct relationship to the amount of the employee's individual performance score (*e.g.*, a 20% increase in the individual performance score would result in a 20% increase in the employee's bonus). This is so because the individual performance score is one of the factors used to determine the employee's (the other factors being company, sector, and/or unit performance scores), and the in turn is one of the factors used to determine the employee's bonus (the others being the employee's and). Thus the amount of an employee's bonus generally varies directly with the employee's individual performance score. An exception lies where one of the factors in the formula is below the minimum threshold set by a Plan, in which case there will be no bonus at all. For example, if an employee's score from his performance appraisal is below the minimum threshold ( ), the employee will receive an individual performance score of zero, which, when plugged into the formula, will result in a bonus of zero.

Where bonuses amounts are dependent in whole or part on some subjective determination made after yearend (such as a performance appraisal) the fact of liability and amount of liability prongs of the all events test are not met because such subjective determinations are necessarily one of the events that fix the fact and amount of the liability. In the case of the Plans in question, the amount of an employee's bonus, and even whether there will be any bonus at all, turns on an individual performance score that turns on an individual performance appraisal that is not conducted until after the close of the year. 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.

TAXPAYER'S ARGUMENTS

The Taxpayer first argues that its liability for the bonuses was fixed under its "pre-established" bonus Plans at yearend "both for individual employees and in the aggregate."[9] Protest, Arg. V.A.1.a.&b. The Taxpayer's Protest does not articulate how the bonuses were fixed as to individual employees other than to assert that it is so

[8] Beginning with the fiscal year , some Plans provide that the individual employee performance component of the bonus is "additive" rather than one factor in a single formula that determines the entire bonus. In such cases, the employee's performance score only impacts a portion of the potential bonus (generally percent).

[9] The Protest characterizes the Service's position as being that the Taxpayer's right to modify or eliminate the bonuses creates a "contingency." Protest, pp. 16 & 20. Contrary to the Taxpayer's characterization, it is the Service's position that the right to modify or eliminate the bonuses prevents the creation of a legal obligation to pay the bonuses in the first instance.

because the "Plan formulas are so specific." Protest, p. 16. The question of when the bonuses are deductible, however, does not turn on the formulas' specificity or lack thereof. Rather, as discussed above, deductibility turns on whether liability is fixed at yearend, and the Taxpayer's liability for the bonuses is not so fixed because the Taxpayer can modify or eliminate the bonuses at will. See United States v. Hughes Properties, Inc., 476 U.S. 593, 602-603 (1986)(liability for progressive jackpots was fixed by the last play of the machine before the end of the fiscal year since it was the last play that "fixed the jackpot amount *irrevocably*" (emphasis added)). Likewise, liability for bonuses under the Plans is not fixed until the bonuses are approved by the Committee, and liability for bonuses under those Plans including an individual performance component is not fixed until the employee's performance appraisal is completed.

Citing Rev. Rul. 2011-29, 2011-49 I.R.B. 824 and The Washington Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969), the Taxpayer attempts to bring itself within the rule that to be deductible for the year, bonuses need only be fixed in the aggregate by yearend, not as to each individual recipient. Protest, pp.16-21. While the principle cited by the Taxpayer is correct, it's inapplicable in this case. Rev. Rul. 2011-29 holds that a taxpayer can meet the fact of liability prong of the all events test for bonuses payable to a group of employees even though the taxpayer does not know the identity of the particular bonus recipients or the amount payable to specific recipients until after the end of the taxable year. The facts of the revenue ruling were that the total amount of bonuses payable under the taxpayer's bonus program was determinable either (1) through a formula that was fixed prior to the end of the taxable year, taking into account yearend financial data, or (2) through other corporate action, such as a resolution of the taxpayer's board of directors made before yearend, fixing the bonuses payable to the employees as a group. To be eligible for bonuses, employees had to be employed on the date the bonuses were paid. Bonuses amounts allocable to employees who were not employed on the payment date were reallocated among other eligible employees. Thus, the aggregate amount of the bonuses payable to employees would not be reduced by the departure of an employee before payment of the bonuses. Based on these facts, and the reasoning that the taxpayer "is *obligated* under the program to pay to the group the minimum amount of bonuses" (emphasis added), the ruling holds that the amount of bonuses payable to the employees as a group is fixed at yearend.

This case does not come within the holding of Rev. Rul. 2011-29. In the revenue ruling, if one employee was given a lesser bonus or no bonus at all, his bonus would be reallocated among the other employees. Accordingly, the aggregate amount of the bonuses would not change, regardless of the bonus given any particular employee. Further, the taxpayer in the ruling was *obligated* to pay an aggregate bonus amount as determined under a fixed formula or by board action. Here, if a particular employee is given a lesser bonus or no bonus at all, his bonus is not reallocated among the other employees.[10] More importantly, because it retains the right to modify or eliminate the

[10] At various points the Protest implies, without actually so stating, that the Plans provide for an

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.[11]

The Taxpayer next argues that it had "a fixed obligation to pay the minimum bonus amounts under the plan, based on its historic practices."[12] Protest, Arg. V.A.1.c. There are two initial factual problems with this argument. First, there are no "minimum bonus amounts" under the Plans. The Plans provide for individual employee bonuses as calculated using formulas contained in the Plans; they do not provide for any "minimum" bonuses, either individually or collectively. Second, the Taxpayer has not established its actual "historic practices." The Protest asserts that "the Company always approved payment of the aggregate performance bonus that was determined pursuant to the pre-established bonus formula" (Protest p. 22), but this assertion is unsubstantiated. Moreover, the assertion is belied by the fact that for both of the years in issue, the Committee made post-yearend discretionary adjustments to the computation of certain company-wide metrics (*i.e.*, the for and the for) that changed the amount of the bonuses ultimately paid for those years.

Wholly apart from the factual difficulties noted, the Taxpayer lacks a legal basis for its argument that its historic practice of paying bonuses as calculated under the Plans created a legal obligation to pay the bonuses. The Taxpayer relies on Sathe v.

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aggregate bonus amount to be paid out for the year. The bonus formulas contained in the Plans determine individual employee bonuses, not an aggregate bonus amount or pool. Nothing in the Plans provide for an aggregate bonus amount.

[11] For the same reason, *i.e.*, that they involve situations where a taxpayer was obligated at yearend to pay an aggregate amount, the other authorities cited by the Taxpayer in Arg. V.A.1.a. are equally inapposite.

[12] The Protest also argues, in passing, that the Plan provisions reserving to the Taxpayer the right to modify or eliminate the bonuses do not relieve the Taxpayer from its legal obligation to pay the bonuses "since the disclaimers were contradicted by the promises in the Bonus Plans that if the stated corporate financial goals were met, and . . . the individual performance ratings were satisfactory . . . the bonuses would be paid." Protest, p. 21. Taxpayer's reading of the Plans is wholly untenable. See Namad v. Salomon, Inc., 543 N.E.2d 722, 723 (N.Y. 1989) and Rakos v. Skytel Corp. 954 F.Supp 1234, 1238 (N.D. Ill. 1996)(rejecting similar readings of bonus plans with comparable disclaimer provisions). The disclaimers were plainly intended to allow the Taxpayer to disavow the so-called "promises," and any other reading of the Plans is nonsensical. Further, to the extent the Plan provisions constituted contractual promises, they are "illusory promises." See Spooner v. Reserve Life Insurance Co., 287 P.2d 735 (Wash. 1955)(bonus plan that contained a reservation of rights clause giving the employer the right to withhold, increase, decrease, or discontinue bonuses was an unenforceable "illusory promise"). As explained in Spooner, "[a] supposed promise may be illusory because it is so indefinite that it cannot be enforced, or by reason of provisions contained in the promise which in effect make its performance optional or entirely discretionary on the part of the promisor." Id. at 737-738 (citations omitted).

Bank of New York, 1990 WL 58862 (S.D.N.Y. 1990),[13] but Sathe not only doesn't support the Taxpayer's argument, it affirms the principle that an employer can reserve to itself the right to modify or eliminate bonuses by explicitly so providing in its plan. Sathe, the plaintiff in the case, was an employee of Irving Trust, and was a participant in a bonus plan that provided that the plan committee could award bonuses based on certain criteria as set forth in the plan. The plan included a provision providing that the plan could be "amended, terminated or revoked at any time by the Chairman" of Irving Trust, and that prior to payment of the bonuses the chairman had "the power to revoke and nullify any and all steps previously taken towards making any award to any person." The plan committee determined that Sathe merited a $400,000 bonus, but before the bonus was paid, Irving Trust was acquired by BONY. Subsequent to the acquisition, however, BONY reduced Sathe's bonus to $100,000. For purposes of the defendant's summary judgment motion, the court assumed that the bonus plan created a contract. Notwithstanding the presumed existence of a contract, the court held that BONY had the right to reduce the amount of Sathe's bonus "[s]ince the Plan under which Sathe is claiming the right to a bonus also contains clear language as to the discretionary nature of the bonus award." None-the-less, the court denied BONY's motion for summary judgment, because, contrary to the terms of the bonus plan, the bonus was modified by someone other than chairman of Irving Trust, thereby arguably breaching the terms of the assumed contract. It was on this basis, and this basis only, that BONY's motion for summary judgment was denied.[14]

Citing Massachusetts Mutual Life Ins. Co. v. United States, 103 Fed. Cl. 111, 128 (Fed. Cls. 2012), the Taxpayer next argues that "'a liability need not be legally enforceable to be fixed under the 'all events test.'" Protest, p. 23. As noted above, liability for an expense is generally fixed by the event that creates legal liability for the expense, but liability can be fixed by any event that creates "an absolute liability." Id. (citing Hughes Properties, Inc., 476 U.S. at 605-606). Here, however, there is no such

[13] The Taxpayer cites, without discussion, a number of cases in addition to Sathe. The cited cases are inapposite as none involve bonuses plans wherein the employer reserved the right to modify or revoke bonuses otherwise earned under plans' terms as is the case here. The cases are distinguishable on other grounds as well. Bonnell/Tredegar Industries, Inc. v. NLRB, 46 F.3d 339 (4th Cir. 1995), for example, is a collective bargaining case decided under provisions of the National Labor Relations Act that have no applicability here. Waite v. A.S. Battiato Co., Inc. 469 N.W. 2d 766 (Neb 1991) involves an actual contract (not an implied contract) modified by the parties' course of conduct. Harden v. Warner Cable Communication, Inc., 642 F.Supp 1080 (S.D.N.Y. 1986), Pillois v. Billingsley, 179 F.2d 205 (2nd Cir. 1950), and Hainline v. General Motors Corp, 444 F.2d 1250 (6th Cir. 1971) are all distinguishable for reasons stated in Sathe. In Hill v. Kaiser Aetna, 313 P. 2d 633 (Cal. Ct. App. 1982), an employee continued his employment with a business in reliance on express promises that an old compensation program would continue under a new owner, a far different scenario than exists here.

[14] See Bessemer Trust Co., N.A. v. Branin, 498 F.Supp. 2d 632 (S.D.N.Y. 2007)(Sathe distinguished by same court that decided it on the ground that "[t]his denial [of summary judgment] was based on the fact that the plan specifically gave discretion to the Chairman, but another party exercised it").

other event to fix liability for the bonuses prior to yearend. The Taxpayer points to Willoughby Camera Stores, Inc. v. Commissioner, 125 F.2d 607 (2nd Cir. 1942), presumably to suggest that the Committee's approval of the Plans was sufficient to fix its liability for the bonuses. Willoughby Camera, however, does not support the Taxpayer's position, as the court's holding there was in fact premised on the taxpayer's legally liability.

The taxpayer in Willoughby Camera represented to its employees, at the time of hire, that after two years of service they would be entitled to participate in a general bonus program. Each December the taxpayer's board determined the amount of the bonuses that would be paid for the year, which amount was set up on the taxpayer's books as a reserve but was not paid until the following year. Under the facts of the case, the Second Circuit found that the taxpayer was *legally liable* for the bonuses. Id. at 609 ("[t]hat obligation [the bonuses] could have been enforced by the employees") & footnote 3 ("there was here an enforceable obligation in the amount accrued"). It was on that basis that the court found that the bonuses were deductible in the year determined by the board. This case is distinguishable from Willoughby Camera in that the Taxpayer here, having expressly disclaimed liability, has no legally liable for the bonuses at yearend.

The Taxpayer makes the alternative argument that the bonuses are fixed by the doctrine of promissory estoppel. Protest, V.B. The Taxpayer's argument is, in essence, that it has made a promise to its employees to pay bonuses per the Plans' terms and it is legally bound by that promise, even if the promise does not create a contract. The doctrine of promissory estoppel provides that "a promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise." Restatement, Second, Contracts, § 90.

Promissory estoppel does not apply here for essentially the same reason that that the Plans do not create an implied contract between the Taxpayer and its employees. For promissory estoppel to lie, the putative promisee (here the employee) must have a *reasonable* basis for his reliance. Where an employer's bonus plan explicitly states that the employer reserves the right to modify or eliminate the bonus, or that it does not create a contract, any reliance on the plan is necessarily unreasonable, and accordingly there can be no promissory estoppel. See, e.g., Geras v. IBM, 638 F.3d 1311, 1317 (10th Cir. 2011)("[b]ecause the incentive letter made clear IBM's intent not to enter into an enforceable contract to provide incentive payments, plaintiff cannot succeed on a contract or promissory estoppel claim based on this letter or the incentive plan it described"); Hart v. Sprint Communications Co., 872 F.Supp. 848, 857 (D. Kan. 1994) ("[w]hen a contract grants or reserves discretion to one party, the other party cannot legitimately maintain a reasonable expectation that such discretion or judgment will not be exercised"); Moore v. Illinois Bell Telephone Co., 508 N.E. 519, 521-522 (Ill. App. Ct. 1987). ("As explained in the discussion of why no enforceable contract rights were created, the three sentences [*i.e.*, the disclaimer] . . . made it clear that defendant

was promising nothing in its Incentive Plan. Therefore, there was no promise unambiguous in its terms, and the doctrine of promissory estoppel is inapplicable.").

Here each of the Taxpayer's Plans provides, *inter alia*, that "

;" that the Plan "
;" that the Taxpayer "

;" and that "

." In light of these explicit disclaimers, any reliance on the part of the Taxpayer's employees would be patently unreasonable and therefore the Taxpayer could not be promissorily estopped.

The Taxpayer cites a number of cases to support its argument that it would be promissorily estopped from modifying or eliminating bonuses under the Plans. The cases cited are distinguishable, irrelevant, and/or unsupportive of the Taxpayer's argument.[15] The only one that involves a disclaimer,[16] and the only one that arguably supports the Taxpayer's position, is McGough v. Broadwing Communication, Inc., 177 F.Supp. 2d 289 (D.N.J. 2001). The plaintiffs in McGough were two sales managers who alleged that they were entitled to override commissions, management bonuses, and stock options. When the managers' original employer was acquired by the defendant Broadwing, Broadwing instituted a compensation plan which allowed the managers to earn override commissions. The plan included a disclaimer which provided the plan was "not a contract" and that the company "may modify or terminate the Plan at any

[15] See, Thomson v. Saatchi & Saatchi Holdings (USA), Inc., 958 F.Supp. 808, 824-827 (W.D.N.Y. 1997), aff'd, in unpublished opinion, 159 F.3d 1348 (2d Cir. 1998)(decided on contract principles, not promissory estoppel (employer denied summary judgment on ground that bonus plan was ambiguous); in dicta, court stated that "[a] promise to pay a bonus is unenforceable . . . if the written terms of the bonus plan make clear the employee has 'absolute discretion' in deciding whether to grant or pay a bonus"); Central Texas Micrographics v. Leal, 908 S.W. 2d 292, 298 (Tex. App. 1995)(employer promised to share proceeds from pending litigation if employee agreed to continue employment and work on litigation; promissory estoppel was alternative basis for holding); Vaughan v. Rehab One, Inc., 1994 WL 91198 (Minn. Ct. App. 1994)(employer held to terms of unsigned employment agreement; promissory estoppel was alternative basis for holding); Bankey v. Storer Broadcasting Co., 443 N.W.2d 112 (Mich. 1989)(decided on contract principles (handbook exception to the employment-at-will rule), not promissory estoppel; held employer may unilaterally change its written policies without having expressly reserved the right to do so); Lucian v. All States Trucking Co., 171 Cal. Rptr. 262 (Cal. Ct. App. 1981)(decided on contract principles, not promissory estoppel; employees not entitled to bonus where they left company prior to yearend, contrary to requirements of bonus plan).

[16] The employer in Thomson argued that bonuses were discretionary under the plan at issue, but court found the plan ambiguous and denied the employer's motion for summary judgment on the ground that there was a genuine issue of material fact. Thomson, 958 F.Supp. at 825.

time or without notice." Id. at 295. The managers alleged that in addition to the compensation plan, they had a separate oral agreement with Broadwing that also provided for the override commissions. Id. at 296. Ultimately the court denied Broadwing's motion for summary judgment as respects the override commissions, stating that the managers had "sufficiently alleged the existence of an implied contract with regard to the nature and amount of the compensation promised to them." Id. at 297. However, the court granted Broadwing's motion for summary as respects the management bonuses and stock options.

McGough provides no support for the Taxpayer's promissory estoppel argument as it was decided not on the basis of promissory estoppel, but rather on an implied contract theory. Moreover, it is factually distinguishable from the present case in that it addresses entitlement to commissions, not bonuses. Commissions are inherently different than bonuses in that they are generally considered part of the employee's base compensation, whereas bonuses are considered to be in addition to base compensation and often (as here) are based largely on the company's overall success, rather than the efforts of the individual employee. As such, courts have historically not treated them the same. Lastly, to the extent McGough is considered to be on point, it is clearly an outlier contrary to the overwhelming weight of authority, as is shown by the cases cited above. See pages 6-8, above.

Lastly the Taxpayer argues that "[t]he fact that certain ministerial acts . . . were completed after year-end also had no effect on satisfaction of the 'all events test.'" Protest, V.C. The only act that the Taxpayer specifically identifies as "ministerial" is the completion of the employee appraisals, but presumably its argument also extends to the Committee's post-yearend approval of the bonus plan settlement and payment. The general principle cited by the Taxpayer, that accrual of an item is not prevented by the nonperformance of a ministerial act, is correct. See Continental Tie & Lumber 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). Completion of the employee appraisals and Committee approval of the bonus plan settlement, however, are more than ministerial acts.

A ministerial act is one "performed without the independent exercise of discretion or judgment." Black's Law Dictionary (9th ed. 2009)(see act, ministerial). Here completion of the employee appraisals and Committee approval of the bonus plan settlement are both acts that require "discretion or judgment" and therefore are not merely ministerial acts. The determination of an employee's individual performance score as part of his individual performance appraisal plainly requires the exercise of discretion and judgment by the supervisor rating the employee. See pages 10-11, above. Likewise, the Committee's approval of the bonus plan settlement and payment requires the exercise of the Committee's discretion and judgment; if it didn't, the whole exercise would be superfluous. And for both the years in issue, the Committee did, in fact, made discretionary adjustments to the computation of certain company-wide

metrics that changed the amount of the bonuses ultimately paid (specifically to the for and to the for). See pages 9-10, above.

The cases cited by the Taxpayer in support of its argument that the employee appraisals and the Committee's post-yearend approval are ministerial are not on point. In both McKenzie Construction and American Snuff, the bonuses at issue were to be computed as a percentage of the company's net profits. Once the percentage was fixed, which in both cases occurred prior to yearend, determination of the bonus amounts was simply a computational matter allowing no exercise of discretion or judgment. The fact that the bonus amounts were initially computed improperly did not alter the amount properly accruable. McKenzie Construction Co. v. United States, 214 F.Supp. 738, 739-740 (W.D. Tex. 1962)("[t]he computation of the bonuses due for the year 1953 remained uncertain only to the extent that the exact amount of net profits was unknown (but not unknowable) at the end of the year"); American Snuff Co. v. Commissioner, 93 F.2d 201, 202 (6th Cir. 1937), cert. denied, 303 U.S. 662 (1938)("[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"). See also footnote 7, above (discussing Rev. Rul. 55-446).

Neither Champion Spark Plug nor Willoughby Camera address what constitutes a ministerial act or the impact of the nonperformance of such an act on accrual. Rather, both cases address the issue of when action by a taxpayer's board of directors is sufficient to fix liability for an expense. In those cases, the fact of liability prong of the all events test was held to have been met because the taxpayer's board took action to obligate itself for the expense. Champion Spark Plug Co. v. Commissioner, 30 T.C. 295 (1958), nonacq. 1958-2 C.B. 3, aff'd, per curium, 266 F.2d 347 (6th Cir. 1961)(board "desired to obligate itself to make the payments"); Willoughby Camera Stores, Inc. v. Commissioner, 125 F.2d 607 (2d Cir. 1942)("[i]f the directors' decision had been subject to revocation, the existence of a formula by which an employee could compute his share of a tentative amount would add nothing to the propriety of an accrual"). Compare H.B. Ives Co. v. Commissioner, 297 F.2d 229 (2nd Cir. 1961). See pages 8-9 (discussing Champion Spark Plug and H.B. Ives) & 15 (discussing Willoughby Camera), above. Here, by contrast, the Taxpayer, through the disclaimer, explicitly disavows liability for the bonuses. To the extent the Taxpayer's board takes action to obligate the company for the bonuses, it only does so after yearend at such time as the Committee approves the bonus plan settlement and payment. Produce Reporter Co. v. Commissioner, 18 T.C. 69 (1952), aff'd 207 F.2d 586 (7th Cir. 1953) is distinguishable on similar grounds.

This advice has been coordinated with Branch 1 of Income Tax & Accounting. Please feel free to call me if you have further questions respecting this matter.

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