

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **200949040**

Release Date: 12/4/2009

CC:ITA:B01:JKristall
PRENO-134562-09

Third Party Communication: None
Date of Communication: Not Applicable

UICL: 461.01-00

date: July 28, 2009

to: Jack Forsberg
Senior Counsel
(Large & Mid-Size Business)

from: John Moriarty
Branch Chief, Branch 1
(Income Tax & Accounting)

subject: Accrual of Bonus Compensation

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Sub1 =
Sub2 =
Sub3 =
Sub4 =
Charity =
Date1 =
Date2 =
Date3 =
Date4 =
Year1 =
Year2 =

SUMMARY

This memorandum responds to your request for help in determining when a liability arising from bonus compensation is taken into account. For the reasons

discussed below, we conclude that a liability arising from bonus compensation is taken into account in the year the bonuses are paid if the taxpayer's employees must still be employed to receive their bonuses. Please contact Jason Kristall at (202) 622-5020 if you would like further assistance or have any questions about this memorandum or our conclusion.

FACTS

On Date2, Taxpayer filed a Form 3115, Application for Change in Accounting Method, on behalf of itself and four subsidiaries,¹ requesting to change its method of accounting for non-executive incentive compensation (bonuses) for the taxable year beginning Date1, and ending Date4. The taxpayer is a corporation and uses an accrual method of accounting for federal income tax purposes.

Under the taxpayer's non-executive incentive compensation plan, employees are required to be employed by the taxpayer on the date that bonuses are paid in order to receive such compensation. Any amounts not paid to employees as bonuses are forfeited and revert back to the taxpayer. In its Form 3115, the taxpayer proposed to treat bonuses as incurred in the taxable year in which all events have occurred to establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Specifically, under the proposed method, the all events test would not be satisfied and economic performance would not occur until such time as the bonuses are deemed paid under § 404(a) of the Internal Revenue Code and § 1.461-4(d)(2)(iii) and 1.404(b)-1T of the Income Tax Regulations. The taxpayer's request was granted on Date3.

After signing its consent agreement, the taxpayer, in a memorandum dated Date4, obligated itself "to pay 90% of the amount accrued for financial statement purposes with respect to [the non-executive] incentive compensation plans . . . related to the fiscal year ended [Date4,]" within the first two and a half months of Year2. Any amounts not paid to employees would be paid to Charity as a charitable contribution. For tax year Year1, no such charitable contribution was made because bonuses in excess of the 90% threshold were paid. The Year1 bonuses were paid during the first two and a half months of Year2.

The 90% obligation was not made a part of the company's bonus plan and was not communicated to the employees in Year1 because it did not alter the bonus plan or terms for the employees. The obligation is expressed in a memorandum from the President/CEO and Executive Vice President/CFO to "Files." Under a Delegation of Authority, the Board of Directors has given the President/CEO authority to act on behalf of the Board as well as the Company in all matters, with approximately 10

¹ Sub1, Sub2, Sub3, and Sub4.

exceptions. Making non-executive incentive compensation decisions and giving charitable contributions to Charity are not among those exceptions.

LAW

Section 461(a) provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 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 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.

Section 461(h)(1) provides that, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 1.461-1(a)(2)(iii)(D) provides, in part, that except as otherwise provided in any regulation, revenue procedure, or revenue ruling, the economic performance requirement of § 461(h) is satisfied to the extent that any amount is otherwise deductible under § 404 (employer contributions to a plan of deferred compensation).

Section 404(a) provides that if compensation is paid or accrued on account of any employee under a plan deferring receipt of such compensation, such compensation shall be deductible subject to the limitations of § 404.

Section 1.404(b)-1T, Q&A 2(a) provides that for purposes of § 404(a), (b), and (d), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed.

Section 1.404(b)-1T, Q&A 2(b)(1), provides that a plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered.

Section 1.461-1(a)(2)(iii)(B) provides that if a liability is subject to § 170 (charitable contributions), the liability is taken into account as determined under that section and not under § 461.

Section 170(a)(2) provides that in the case of a corporation reporting its taxable income on the accrual basis, if the board of directors authorizes a charitable contribution during any taxable year, and payment of such contribution is made after the close of such taxable year and on or before the 15th day of the third month following the close of such taxable year, then the taxpayer may elect to treat such contribution as paid during such taxable year. The election may be made only at the time of the filing of the return for such taxable year.

ANALYSIS

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. Section 461(h) and § 1.461-1(a)(2)(i). See *also* § 1.446-1(c)(1)(ii)(A).

To satisfy the all events test for determining when an item is incurred for federal income tax purposes, the liability must be final and definite in amount, must be fixed and absolute, and must be unconditional. *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 600 (1986). “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 on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future.” *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 34 (1988). “It is fundamental to the ‘all events’ test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established.” *United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987). See *also* Rev. Rul. 2007-3, 2007-1 C.B. 350. 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, *supra*, (citing Rev. Rul. 80-230, 1980-2 C.B. 169, and Rev. Rul. 79-410, 1979-2 C.B. 213).

In this case, the taxpayer pays bonuses to its non-executive employees under a plan that requires employees to be employed by the taxpayer on the date that bonuses are paid in order to receive that compensation. Under the terms of the bonus plan, any amounts not paid to employees by virtue of their leaving the company revert back to the taxpayer. A liability for bonus compensation paid under such a plan is not a fixed liability in the year of the related service. Liabilities meet the all events test only to the extent that they are firmly established and not contingent. See *General Dynamics*, 481 U.S. at 243. Where, as here, employees cannot receive bonuses unless they are employed on the date of payment, the liability for that bonus compensation is subject to a contingency. Therefore, the liability does not become

fixed until the contingency is satisfied—that is, when the employee is still employed on the date of payment and receives the bonus compensation.

In addition, the all events test is not satisfied any earlier than when economic performance with respect to a liability occurs. Section 461(h). For liabilities arising from services or property provided to the taxpayer, economic performance occurs as the services or property is provided. Section 1.461-4(d)(2). In this case, the taxpayer's bonus plan requires employees to continue their service to the company until the date that bonuses are paid. Therefore, even though bonuses may be based on the company's performance in Year1, economic performance does not occur and the liability is not fixed until the date that bonuses are paid because service must continue until that time.

Further, the taxpayer is not entitled under § 170 to accrue a liability for a charitable contribution in Year1. As noted above, § 170(a)(2) provides that certain corporations may treat contributions made after the close of the taxable year and on or before the 15th day of the third month after the close of that year as paid during the year if the corporation's board of directors authorized the contribution during that taxable year. However, in this case the taxpayer did not make any charitable contributions. As a result, § 170(a)(2) does not apply and the taxpayer may not rely on it to accrue an amount in Year1.

The taxpayer asserts that it had a fixed and determinable liability at the end of Year1 for 90% of the amount accrued for financial statement purposes for the non-executive incentive compensation plans for Year1 and that, as a result, it is entitled to take that amount into account in Year1 under §§ 404(a) and 461. It reasons that the combination of its non-executive incentive compensation plans and its obligation to contribute to Charity any amounts not paid to employees was sufficient to fix its liability. The taxpayer's reasoning is not persuasive. Sections 170 and 461 apply to different types of liabilities and provide different timing rules for those liabilities. The failure to contribute funds to Charity does not mean that the taxpayer necessarily satisfies the requirements of § 461. As noted above, § 170(a)(2) does not govern the timing of the accrual in this case as the taxpayer did not make any payments to Charity. Rather, the only amount in question was bonus compensation and, as explained above, that liability was not fixed in Year1 as the employees had to perform services in Year2 and actually be employed by the taxpayer when the bonus was paid in order to receive the bonus. Further, the cases cited by Taxpayer in support of its position are distinguishable because they involve only one type of liability. See *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d 607 (2d Cir. 1942); *Washington Post Co. v. U.S.*, 405 F.2d 1279 (Ct.Cl. 1969); and *Produce Reporter Co. v. Commissioner*, 18 T.C. 69 (1952). Unlike the situation in those cases, Taxpayer did not know at the end of Year1 whether it owed bonus compensation to any employee. In addition, the facts do not indicate that Taxpayer's employees could require it to make a contribution to Charity in the absence of bonus payments.

CONCLUSION

Under the facts described above, the taxpayer's liability for bonus compensation is taken into account in the year the bonuses are paid.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.