Office of Chief Counsel
Internal Revenue Service
Memorandum

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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 =
Year1 =
Year2 =
Year3 =

SUMMARY

This memorandum responds to your request for help in determining when Taxpayer's liability arising from bonus compensation is taken into account. For the reasons discussed below, we conclude that Taxpayer's liability arising from bonus compensation is taken into account in the year the bonuses are paid because Taxpayer's employees must still be employed to receive their bonuses and because forfeited amounts revert back to Taxpayer. 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

Taxpayer pays bonuses to its eligible employees under its incentive compensation plan (ICP). Bonuses for each eligible employee are accrued for book purposes pursuant to a formula based on the sum of all target ICP awards. The total accrual is adjusted throughout the year based on the company's performance relative to pre-established income goals (as approved by Taxpayer's compensation committee in February of the plan year) and also based on changes in the number of eligible employees throughout the year. The aggregate amount of bonuses accrued for book purposes is finalized at year end based on the number of eligible employees employed on December 31st of the plan year.

Under the ICP, target bonus awards are planned during the annual compensation planning process in January or February of each plan year. Individual awards may vary based on individual performance, but the aggregate amount paid as bonuses generally does not exceed the amount accrued for book purposes at year end. To receive a bonus, eligible employees must remain employed until bonuses are paid following the end of the plan year.

At its February meeting following the plan year, the compensation committee meets to review and approve bonus awards paid under the ICP. The year-end bonus accrual is inputted into an HR tool, and each of Taxpayer's section managers are allotted a total bonus amount to allocate among the employees. Any employee who leaves Taxpayer's employment prior to the section manager allocating the bonuses among that section's eligible employees forfeits his or her right to a bonus, and the total amount is allocated among the employees who remain. However, once the section manager finalizes the individual bonus awards in the HR tool, forfeited amounts are not reallocated among any remaining eligible employees; rather, they are forfeited back to Taxpayer.

For tax purposes during Year1 and Year2, Taxpayer took its liability for bonuses into account in the year of service. However, in Year3, Taxpayer began taking its liability for bonuses into account in the year paid because the taxpayer did not believe that it had a fixed liability to pay bonuses. Now, Taxpayer argues that it qualifies for treatment under Rev. Rul. 2011-29, 2011-49 I.R.B. 824 (December 5, 2011), because the amount of bonuses actually forfeited represents only a *de minimis* portion of the bonuses accrued at year end and paid by March 15th of the following year.

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.

Rev. Rul. 2011-29 holds that an employer can establish the "fact of the liability" under § 461 for bonuses payable to a group of employees even though the employer does not know the identity of any particular bonus recipient and the amount payable to that recipient until after the end of the 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).

The first prong of the all events test requires that all the events have occurred that establish the fact of the liability. Generally, all events occur to establish the fact of a liability when (1) the event fixing the liability, whether that is the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, 2007-1 C.B. 350; Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, *amplified by* Rev. Rul. 2003-90, 2003-2 C.B. 353. Although an expense may be deductible before it is due and payable, liability for the expense first must be firmly established. *United States v. General Dynamics Corp.*, 481 U.S. 239, 243-4 (1987).

In this case, Taxpayer pays bonuses to its eligible employees under a plan that requires employees to be employed by Taxpayer on the date that bonuses are paid in order to receive that compensation. Though section managers are allotted a specified amount of bonuses to allocate among the eligible employees, once an employee's individual bonus award is set in the HR tool, it will not be reallocated among the remaining employees if that employee should seek to leave. Under the terms of the ICP, any amounts not paid to employees by virtue of their leaving the company after the individual awards are set in the HR tool revert back to Taxpayer. Therefore, Taxpayer's liability to pay bonuses is not a fixed liability in the year of the related service. Rather, the liability becomes fixed only if the contingency is satisfied—that is, when the employee is still employed on the date of payment and receives the bonus compensation. There is no *de minimis* exception to this rule.

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

In Year3, Taxpayer began taking its liability for bonuses into account in the year paid. Apparently, Taxpayer changed its method of accounting for bonus compensation at that time, though it seems they did so without filing a Form 3115, *Application for Change in Accounting Method*. Such a change would be one made without consent. The examining agent should consult Rev. Proc. 2002-18, 2002-1 C.B. 678, when resolving Taxpayer's accounting method issue regarding its bonus liability.

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.