

Annual Bonus Plans: Managing Audit Exposure

By James Atkinson and Anne Batter

Whether a company may deduct compensatory bonuses in the same year in which the employees provide the services for which they are being rewarded is attracting increased attention from both financial and IRS auditors. The issues arising from both forms of audit scrutiny are taking many companies by surprise, because the current deductibility of amounts paid under their annual bonus plans has gone largely unchallenged for many years.

Increasingly, companies are being told by their financial auditors that they have been accounting for annual bonuses improperly, and that the company either must begin deferring those deductions to a later year or establish a FIN48 reserve for the payments. With the Internal Revenue Service's recent announcement that companies may be required to provide greater "transparency" of the issues for which they have established reserves, determining the correct year in which to deduct annual bonuses is taking on even greater importance.

Most companies have one or more compensatory bonus plans for employees. Many have separate plans for managers and for non-managers. Companies also typically have separate bonus plans for highly compensated individuals (so-called section 162(m) plans). The structure and terms of these plans vary significantly from employer to employer, but two common provisions have led to substantial angst regarding the ability to deduct bonuses in the same year in which the employee performs services ("the service year").

Discretion to Reduce Pool

Many plans provide a formula or other mechanism for creating a year-end bonus pool to be shared among eligible employees, but reserve to management the ability to increase or decrease the actual amount paid to employees once year-end financial results become available and other indicia of individual, business unit, and company performance have been considered. In many cases, this discretion takes the form of requiring the Board of Directors, the compensation committee, or the CEO or CFO to review and approve the amount of the bonus pool before any amount becomes due and payable under the plan.

Because, under this plan design, these decisions necessarily occur after the close of the service year, such provisions raise the issue whether for tax purposes the "all events test" has been satisfied as of the end of that year. Under this standard, the company cannot deduct any portion of the bonus pool for the service year unless its liability is fixed and the amount is reasonably determinable as of the close of that year. Where the company has no obligation to pay any bonuses unless and until designated officials or the Board's compensation committee approve the amount to be paid, there is a substantial risk that the financial auditors and the IRS will conclude that the company does not have a fixed and determinable liability as of the end of the service year. Instead, the deduction is deferred until the following year, when these "conditions precedent" to pay-

ment of the bonus are satisfied.¹ Both the financial auditors and the IRS are likely to take this position even if the company rarely if ever modifies the amount determined under the formula.

Paying the bonuses within two and a half months of the end of the service year is not sufficient to support deduction in the service year. The so-called two-and-a-half-month rule under section 404 only determines whether the bonuses must be treated as deferred compensation; it has no bearing on whether the fact of liability was fixed or the amount was reasonably determinable as of the end of the prior tax year.

In light of this audit exposure, a number of companies are revising their existing bonus plans to eliminate or curtail this retained discretion, so that the fact of liability is fixed as of year end and the amount is reasonably determinable with respect to at least a portion of the anticipated bonuses. For example, some companies commit to paying a fixed dollar amount and communicate this commitment to employees before the end of the service year, but reserve discretion to supplement this pool with additional funds. In those situations, deducting the fixed amount in the service year would be appropriate, with any supplemental amounts deducted in the succeeding year when the board reviews and approves payment of the additional funds. Other approaches, including imposing limits on the exercise of discretion, creating a multi-tier structure involving multiple pools with varying vesting requirements, or restructuring the approval process to function as a "condition subsequent" rather than a "condition precedent" may accomplish this goal as well, with varying degrees of certainty.

Forfeiture Provisions

Many annual bonus plans require recipients to remain employed with the company on the payment date, or else forfeit the bonus. Necessarily, in the absence of special circumstances, this payment date will occur only once the company's financial results have been calculated after the end of the service year. As a result, the company cannot know at the end of the service year how many employees will forfeit their bonuses under this provision nor the aggregate amount that will be forfeited. The critical fact in determining whether a forfeiture provision prevents deducting the bonus pool in the service year is the disposition of forfeited amounts. In general, if the forfeited bonuses return to the company, there is a substantial risk that neither the fact nor the amount of the liability is fixed before the payment date, given uncertainty over the total amount to be disbursed.² Theoretically, the entire pool may be forfeited. Although unlikely, this possibility presents a potential obstacle to accruing any portion of the bonus pool.

On the other hand, if forfeited amounts must be redistributed to the eligible employees remaining on staff as of the payment date, a forfeiture provision should not affect the company's entitlement to deduct the bonuses in the service year.³ Even though the company may not know the identities of the specific individuals who

will receive bonuses, the company does know at year end the total amount that it is obligated to pay to someone. That is sufficient to support a deduction in the service year.⁴

Whether a particular mechanism for redistributing forfeited amounts will support a deduction in the service year is largely a question of fact. For example, the IRS recently issued a private letter ruling concluding that a company's commitment to pay forfeited bonuses to a charity is not sufficient to "fix" the company's liability as of the end of the service year. Instead, the company was entitled to accrue the deduction only in the year the bonuses were paid to employees.⁵

In that same ruling, the IRS also concluded that an employee's obligation to remain on staff until the payment date is a continuing "service" owed to the employer in exchange for the bonus. Under that view, the economic performance requirement of section 461(h) (which must be satisfied in addition to the amount being fixed and reasonably determinable) would not be satisfied until those additional "services" are completed on the payment date. In the IRS's view, this continuing service obligation is an independent basis for disallowing the deduction in the service year.

The IRS's conclusion that simply remaining employed until the payment date is an additional "service" is questionable, and depending on a company's particular facts, may not withstand close scrutiny. For taxpayers not wishing to endure the expense and aggravation of challenging this ruling, a relatively simple amendment to annual bonus plans eliminating any question about which services are being compensated through the bonus payments may be sufficient to distinguish the taxpayer's facts from those in the private letter ruling.

Section 162(m) Plans

It is more difficult to structure section 162(m) plans to permit a current deduction in the service year. As background, section 162(m) of the Internal Revenue Code disallows deductions for most types of compensation paid to a publicly held corporation's "covered employees" (the corporation's CEO and its four other highest-paid employees)⁶ to the extent the compensation exceeds \$1 million. This cap does not apply to performance-based compensation, however, as long as (among other things) the company's compensation committee establishes objective goals in advance and certifies before payment that the performance goals and any other material terms of the plan have been satisfied. Generally, the compensation committee will not be in a position to review and certify compliance with the performance goals before the end of the service year. Additionally, many section 162(m) plans rely heavily on the exercise of negative discretion by the compensation committee (*i.e.*, the ability to reduce the bonus otherwise payable under the performance measures). In other words, section 162(m) plans often establish threshold goals and a relatively large maximum amount payable on attainment of such goals, but the actual bonus paid within the established maximum is determined through the compensation committee's exercise of negative discretion, based on a combination of factors, such as financial performance and other, more subjective considerations. As a result, bonuses payable to covered employees under a section 162(m) plan that relies on the compensation com-

mittee's exercise of negative discretion after year-end will rarely if ever be able to satisfy both section 162(m) and the all-events test before the end of the service year.

Because the limitations imposed by section 162(m) result in a permanent disallowance rather than simply a one-year deferral, ensuring compliance with section 162(m) and a deduction in the first instance is a higher priority than trying to accelerate the deduction into the service year. For this reason, in restructuring their annual bonus plans, most companies retain a separate section 162(m) plan for covered employees (or a separate section 162(m) compliant provision in the regular annual bonus plan) rather than trying to devise a single plan structure for all employees. These companies also tend to accept that the deduction will be delayed for the bonuses paid under the section 162(m) plan.


Going Forward

Many taxpayers confronting potential financial and IRS audit challenges are opting to amend their bonus plans to eliminate this exposure. The goal of the plan revisions is supporting a current deduction in the service year by establishing a minimum amount of annual bonuses irrevocably earned by employees as of the end of that year. The approaches taken in modifying plans vary, but in many cases the amendments eliminate the obligation for the employee to remain on staff on the payment date in order to receive a bonus, and also eliminate the company's discretion to reduce the funds available for distribution to eligible employees. Another alternative is to retain the current bonus plan, but to commit before the end of the year to paying a fixed bonus pool (and to not exercise any retained discretion to pay a lower amount). The mechanisms used to justify an accrual vary, and not surprisingly are affected by business and human resource considerations. These changes generally are made only to the plans covering managerial and non-managerial employees, and do not affect the company's section 162(m) plans.

In addition to modifying existing bonus plans, many companies are taking the additional step of changing the accounting method for their current bonus plans. These companies obtain "automatic" IRS consent to begin accruing the deductions in the year in which no further actions (such as board approval or employee retention) are required to fix the fact and reasonably determine the amount of the liability. Even if the company revises its annual bonus plans to eliminate the financial and IRS audit exposure going forward, requesting consent to change the accounting method for bonuses paid under current plans provides the added benefit of obtaining "audit protection" against IRS challenges to prior-year deductions. Because the IRS now permits these accounting method changes to be made using the so-called automatic consent provisions,⁷ the method change is relatively simple to accomplish and provides insurance against IRS challenges to prior-year deductions commensurate with the effort required.

Bottom Line

Scrutiny of a company's federal tax accounting for annual bonus plans began as a FIN48 issue, but increasingly is a source of IRS audit exposure as well. Even where the same bonus plan has been

in place for many years without being questioned either by financial auditors or the IRS, the current audit climate suggests the need to review the company's tax treatment of annual bonus plans and to take remedial action where appropriate. In many cases, these reviews take relatively little time and the steps required to eliminate the audit risks described above are modest in relation to the advantages to be gained. 

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1. *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987) (all events test not satisfied where prerequisites to payment were not ministerial, regardless of company's ability to closely estimate ultimate payments); *Hitachi Sales Corp. of America v. Commissioner*, T.C. Memo 1992-504 (no deduction for amounts company reasonably expected to pay to distributors where the liability was not yet fixed).
2. *Bennett Paper Corp. v. Commissioner*, 78 T.C. 458 (1982) (denying current deduction where forfeited amounts would revert to the taxpayer-employer rather than being redistributed among the remaining employees eligible to participate in the bonus pool).
3. *The Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969) (permitting deduction in service year where amounts forfeited prior to payment date would be distributed among remaining participants).
4. *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) (deduction permitted for amounts in progressive jackpot at year end despite inability to identify payee).
5. CCA 200949040 (December 4, 2009).
6. Despite the language of the Code, under Notice 2007-49, 2007-25 IRB 1429, because of a change in the securities rules regarding disclosure of executive compensation that are cross-referenced in section 162(m) (3), covered employees now include only the CEO, and the top three highest officers, other than the CEO and CFO.
7. Rev. Proc. 2008-52, 2008-2 C.B. 587, Appendix, § 19.01(2), as modified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, § 2.20.