The Deductibility of Group Bonuses

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It's January. That means employees who worked hard during 2011 may be pleased with year-end bonuses they received or smarting that this year-end was as bad as the last. Amid Wall Street gloom that pay is worse than 2008, we inexhaustibly ask: Are we emerging from the Great Recession?

Bonus checks may be the best barometer of our current economic health. Plainly, bonuses are income to employees and deductible business expenses to employers. However, the *timing* of deductions for bonus payments made by accrual-based taxpayers has long been a point of contention for taxpayers and the IRS.

Why? Reg. §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 tax 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. In tax nomenclature, this is the "all-events test."

Pay Me Now!

With employee bonuses, the first prong of the all-events test, whether the event fixing the liability has occurred or the payment is unconditionally due, causes some consternation. For example, in *Washington Post Co.*, CtCls, 69-1 USTC ¶9192, 405 F2d 1279 (1969), the U.S. Court of Claims examined a taxpayer that paid bonuses to its circulation dealers as a group. If a dealer did not meet certain specified conditions, a portion of the dealer's share of the bonus would be forfeited and reallocated to other dealers. This sounds fuzzy, but not enough to preclude a deduction. Even though the amount and time of actual payout to individual recipients were not determined, the court held that the total amount of the liability was fixed at the end of the tax year and properly deductible. The IRS lost the case but was still steaming.

Consequently, in Rev. Rul. 76-345, 1976-2 CB 134, the IRS announced it would not follow *Washington Post* in similar cases. If a taxpayer's liability was fixed and certain only with respect to a *group*, the all-events test wasn't met, said the IRS. A group is subject to constant change, and the ultimate recipients and time of distribution could not be ascertained in the year of accrual, the IRS claimed.

All for One?

To the IRS, a group bonus payment failed the all-events test because the *fact of the liability* is not clearly established and the *amount of liability* cannot be determined with reasonable accuracy. Despite adhering to this position for 35 years, the IRS recently demonstrated its own year-end magnanimity. In Rev. Rul. 2011-29 (Nov. 9, 2011), the IRS revoked Rev. Rul. 76-345.

In the new ruling, the minimum total of bonuses payable to employees as a group was determinable either (1) through a formula that was fixed prior to the end of the tax year, taking into account financial data reflecting results as of the end of that tax year; or (2) through other corporate action, such as a resolution of the company's board of directors, made before the end of the tax year, that fixed the bonuses payable to the employees as a group. Any bonus allocable to an employee not employed on the bonus payment date was reallocated among other eligible employees.

The IRS conceded the similar issues raised in Rev. Rul. 76-345 and Rev. Rul. 2011-29. But the IRS acknowledged the holding in *Hughes Properties, Inc.*, SCt, 86-1 USTC ¶9440, 476 US 593 (1986). There, the Supreme Court assessed the deductibility of guaranteed slot machine payments that had not yet been won by casino patrons. The Court felt the casino taxpayer had a *fixed* obligation to pay the guaranteed amounts. The identification of the eventual recipients of the jackpots was inconsequential!

In fact, the high court pointed out that the first prong of the all-events test was met. Whether it turned out that the winner was one patron or another made no difference to the liability. That convinced the Court that the casino got its deduction.

Citing *Hughes*, the IRS conceded that the company in Rev. Rul. 2011-29 could establish the fact of the liability for bonuses payable to a group. Even though the company did not know the identity of any *particular* bonus recipient, it was deductible.