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**TO: All Tax Accounting and EB Clients**

**FROM: Les Schneider  
Kevin O'Brien  
Patrick Smith  
Ivins, Phillips & Barker**

**RE: New Field Attorney Advice 20134301F  
Deductibility of Employee Bonuses**

We are writing to you to alert you to an important new Field Attorney Advice, 20134301F released by LB&I (Not the IRS National Office). This FAA addresses a number of important issues faced by taxpayers with employee bonus plans. The important holdings in this FAA are as follows:

### **Principal Holdings**

#### **1. Impact of Employer Reservation of Right to Modify or Cancel Bonuses**

Notwithstanding that a taxpayer's employee bonus plan is in form non-discretionary (i.e., the plan contains a fixed formula for deciding the amount of employee bonuses), if the bonus plan also contains a reservation of rights on behalf of the employer to unilaterally modify or cancel the employee bonuses, the bonuses are not deductible until the bonuses are actually paid to the employees. This same conclusion would also apply where a bonus plan contains formulary criteria that must be satisfied in order for a

bonus to be paid, but the plan reserves discretion to the board of directors (or compensation committee) to deviate from the fixed formula and reduce the amount of the bonuses.

The FAA cites a large number of state contract law cases holding that employees may not sue their employer for breach of contract, if the employer terminates employee bonuses prior to their payment pursuant to a clause in the employee bonus plan reserving in the employer the right to terminate the bonuses. The FAA likewise notes that the doctrine of promissory estoppel is not applicable where the bonus plan expressly reserves in the employer the right to terminate the payment of the bonuses.

## **2. Impact of Requirement that Board of Directors (or Compensation Committee) Approve Bonuses**

If an employee bonus plan contains numerical targets that are satisfied, but the employee bonus plan nevertheless requires the employer's board of directors (or compensation committee) to approve the payment of the bonuses, the bonuses are not deductible until the taxable year in which the bonuses are approved by the board of directors (or compensation committee). The FAA holds that in those circumstances, the employer's legal liability to pay the employee bonuses does not become fixed until the board of directors (or compensation committee) approves the bonuses. Thus, if the board of directors (or compensation committee) approval does not occur until after the end of the year to which the bonuses relate, the bonuses are not deductible in the year to which they relate.

## **3. Bonus Plans with Subjective Criteria for Earning the Bonus**

If an employee bonus plan contains subjective criteria in order for employees to earn their bonuses, such as a performance score that is subjective based on a superior's appraisal of the employee's work, the bonuses are not deductible until the determination takes place as to whether the employee satisfies the subjective criteria for earning the bonus. Thus, if this determination does not take place until after the end of the year to which the bonus relates, the bonus is not deductible in the year to which it relates.

While the FAA does not expressly address this point, we have encountered situations where an employer's bonus plan contains a fixed formula that might appear to meet the all-events test without action by the board of directors (or compensation committee). However, in practice, the formula leaves considerable discretion to the employer to determine whether the bonus criteria are satisfied. These types of plans must be analyzed on a case-by-case basis to determine whether board of directors (or compensation committee) action is required before year end in order to deduct the bonus in the taxable year of accrual.

Finally, many bonus plans contain a requirement for formal certification by an employer that employee performance criteria have been met. This is typical of bonus plans designed to satisfy the requirements of section 162(m). In our view, post-year end certification that criteria for a bonus are satisfied does not, in and of itself, turn a formulary plan into a discretionary plan that precludes deductions until the certification is issued. However, as in the case of bonus plans without a certification feature, if the bonus criteria suggest subjective discretion on the part of the employer as to whether the bonus will be granted, that might prevent deduction of the bonus in the year to which the bonus relates, where the certification does not occur until the year of payment of the bonus.

### **Other Conclusions**

#### **4. Reliance on Group Liability**

Rev. Rul. 2011-29, 2011-49 I.R.B. 824, and *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), hold that an employer's liability to pay an aggregate amount of bonuses to a group of employees may overcome the fact that an individual employee's bonus is forfeitable and permit a deduction of the aggregate amount of the bonuses. However, this doctrine is applicable only if the employer's liability to the group of employees is fixed by the end of the taxable year of accrual. If the employer's group liability is contingent on board of directors (or compensation committee) approval to the same extent as the employer's liability to each individual employee, the group liability concept does not support the deduction of the bonuses prior to board of directors (or compensation committee) approval.

#### **5. Deduction of a Guaranteed Minimum Amount of Liability**

If a portion of an employer's liability to pay employee bonuses is fixed and the balance is discretionary, the fixed portion of the bonuses may be deducted in the taxable year of accrual. However, to qualify under this rule, the fixed portion of the bonus must in fact be fixed under the terms of the employee bonus plan. If board of directors (or compensation committee) action is required even for the guaranteed minimum portion of the bonus (either individually or in the aggregate) or if the guaranteed minimum portion of the bonus could be cancelled by the board of directors (or compensation committee), no portion of the bonuses would be deductible in the taxable year to which the bonuses relate.

#### **6. Impact of Past Practice in Fixing Liability to Pay Employee Bonuses**

The IRS is unlikely to accept the argument that a taxpayer's legal obligation to pay bonuses under the terms of an employee bonus plan that is discretionary according to the terms of the plan is converted into a fixed obligation based on the taxpayer's past practice in paying employee bonuses under that plan.

## 7. Nature of Underlying Obligation to Pay Employee Bonuses

The FAA seemingly accepts the notion that if, as part of a pre-existing employee bonus plan, a taxpayer's board of directors fixes the employee bonuses prior to the end of the taxable year of accrual (assuming no reservation of a right to cancel the bonuses), the bonuses would be deductible in the taxable year to which the bonuses relate. However, this conclusion is subject to some uncertainty based on the analysis in a recent Second Circuit decision, *New York Life Insurance Co. v. United States*, 724 F.3d 256 (2d Cir. 2013). This case is not cited in the FAA, but the FAA cites several of the same cases that the court in *New York Life* relied on for its holding.

In that case, the Second Circuit held that a gratuitous decision by a taxpayer's board of directors prior to the end of the taxable year to pay a dividend to policy holders in the following year (in a context where the dividend is the type of dividend that would be deductible) was not sufficient to satisfy the all-events test in the year the board of directors' resolution was adopted, even though the board's decision was binding and irrevocable. The court cited several older employee benefit cases in which it was held that a board of directors' resolution to pay a discretionary bonus to employees was not deductible until the bonuses were paid to the employees, where the taxpayer was under no binding legal obligation to pay the bonuses at the time the board of directors' resolution was adopted. This suggests that a discretionary bonus is not made mandatory (and therefore fixed under the all-events test) by a board of directors' resolution to pay the bonuses. The holding in the case thus seems more extreme than the positions expressed in the FAA, since the FAA seems to accept that an irrevocable board of directors resolution is sufficient to fix the liability to pay a bonus.

Query whether this same argument could be made in the case of a board of directors' resolution to pay a bonus to employees that is adopted after the employees complete the performance of the work that is being rewarded by the employer, if there was no pre-existing duty imposed on the employer to pay the bonus.

If any of these issues are relevant to your company's employee bonus plans, please contact us to discuss your company's options for fixing the problem.

Les Schneider

Kevin P. O'Brien

Patrick Smith