

Part I

Section 461.-- General Rule for Taxable Year of Deduction

26 CFR 1.461-1: General rule for taxable year of deduction.

Rev. Rul. 2011-29

ISSUE

Can an employer establish the “fact of the liability” under § 461 of the Internal Revenue Code for bonuses payable to a group of employees if 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?

FACTS

X uses an accrual method of accounting for federal income tax purposes. X pays bonuses to a group of employees pursuant to a program that defines the terms and conditions under which the bonuses are paid for a taxable year. X communicates the general terms of the bonus program to employees when they become eligible and whenever the program is changed.

Under the program, bonuses are paid to X's employees for services performed during the taxable year. The minimum total amount of bonuses payable under the program to X's employees as a group is determinable either (a) through a formula that

is fixed prior to the end of the taxable year, taking into account financial data reflecting results as of the end of that taxable year, or (b) through other corporate action, such as a resolution of X's board of directors or compensation committee, made before the end of the taxable year, that fixes the bonuses payable to the employees as a group. To be eligible for a bonus, an employee must perform services during the taxable year and be employed on the date that X pays bonuses. Under the program, bonuses are paid after the end of the taxable year in which the employee performed the related services but before the 15th day of the 3rd calendar month after the close of that taxable year.

Under the program, any bonus amount allocable to an employee who is not employed on the date on which X pays bonuses is reallocated among other eligible employees. Thus, the aggregate minimum amount of bonuses X pays to its group of eligible employees is not reduced by the departure of an employee after the end of the taxable year but before bonuses are paid for that year.

LAW

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting the taxpayer uses to compute taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that, 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 for

the liability (collectively, the “all events test”). See also § 1.446-1(c)(1)(ii)(A). This revenue ruling addresses only whether the first prong of the all events test is met.

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 be 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 Washington Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969), the United States Court of Claims held that a taxpayer incurred a liability to pay bonuses under a plan maintained for the benefit of its circulation dealers as a group. Under the plan, if a dealer did not meet certain specified conditions, a portion of the dealer’s share would be forfeited and reallocated to other dealers. Thus, even though the amount and time of actual payout to individual recipients were, at least in part, not determined, the court held that the total amount of the liability was fixed at the end of the taxable year. In Rev. Rul. 76-345, 1976-2 C.B. 134, the Internal Revenue Service announced that it would not follow Washington Post in similar cases.

In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), the Supreme Court allowed a casino operator to deduct amounts guaranteed for payment of progressive slot machine jackpots that had not yet been won by casino patrons. The Court reasoned that the taxpayer had a fixed obligation to pay the guaranteed amounts, and

that the identification of the eventual recipients of the progressive jackpots was inconsequential. The Court noted that “[t]he obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability.” Hughes Properties, 476 U.S. at 602.

ANALYSIS

X's liability to pay a minimum amount of bonuses to the group of eligible employees is fixed at the end of the year in which the services are rendered. X is obligated under the program to pay to the group the minimum amount of bonuses determined by the end of the taxable year. Any bonus allocable to an employee who is not employed on the date on which bonuses are paid is reallocated to other eligible employees. Thus, the fact of X's liability for the minimum amount of bonuses is established by the end of the year in which the services are rendered. See Rev. Rul. 55-446, 1955-2 C.B. 531, as modified by Rev. Rul. 61-127, 1961-2 C.B. 36 (holding that bonuses payable to ascertainable employees under an incentive compensation plan that has been communicated to the employees, the exact amounts of which are determinable through a formula in effect prior to the end of the taxable year, are properly accruable for Federal income tax purposes for the year to which they relate). This is true even though the identity of the ultimate recipients and the amount, if any, each employee will receive cannot be determined prior to the end of the taxable year. See Hughes Properties, supra. Accordingly, for purposes of the first prong of the all events test under § 1.461-1(a)(2)(i), all the events have occurred by the end of the taxable year that establish the fact of X's liability to pay the minimum amount of bonuses.

HOLDING

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.

APPLICATION

Any change in a taxpayer's treatment of bonuses to conform with this revenue ruling is a change in method of accounting that must be made in accordance with §§ 446 and 481, the regulations thereunder, and the applicable administrative procedures. See section 19.01(2) of the APPENDIX of Rev. Proc. 2011-14, 2011-4 I.R.B. 330, 403.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 76-345 is revoked.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jason D. Kristall of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Kristall at (202) 622-5020 (not a toll-free call).