Abstract: An annual bonus plan can help attract, retain and motivate employees. And if the plan is designed carefully, the taxpayer can deduct bonuses earned this year even if he or she doesn't pay them until next year. This article explains certain rules, such as the 2½ month rule and the all-events test.

Designing a tax-wise bonus plan

An annual bonus plan can be a great way to attract, retain and motivate employees. And if the plan is designed carefully, you can deduct bonuses earned this year even if you don't pay them until next year.

The 2½ month rule

Many employers are aware of the "2½ month rule" and assume they can deduct bonuses earned during a tax year so long as they pay them within 2½ months after the end of that year (by March 15 for a calendar-year company). But that's not always the case.

For one thing, this tax treatment is available only to *accrual-basis* taxpayers — *cash-basis* taxpayers must deduct bonuses in the year they're paid, regardless of when they're earned. Even for accrual-basis taxpayers, however, this treatment isn't automatic. Bonuses can be deducted in the year they're earned *only* if the employer's bonus liability is fixed by the end of the year.

The all-events test

For accrual-basis taxpayers, the IRS determines when a liability (such as a bonus) has been incurred — and, therefore, is deductible — by applying the "all-events test." Under this test, a liability is deductible when:

1. All events have occurred that establish the taxpayer's liability,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance has occurred.

Generally, the third requirement isn't an issue; it's satisfied when an employee performs the services required to earn a bonus. But the first two requirements can delay your tax deduction until the year of payment, depending on how your bonus plan is designed.

For example, many bonus plans require an employee to remain in the company's employ on the payment date as a condition of receiving the bonus. Even if the amount of the bonus is fixed at the end of the tax year, and employees who leave the company before the payment date forfeit their bonuses, the all-events test isn't satisfied until the payment date. As discussed below, however, it's possible to accelerate deductions with a carefully designed bonus pool arrangement.

Everyone into the pool

One solution to the problem described above is to establish a bonus pool. In a 2011 ruling, the IRS said that employers may deduct bonuses in the year they're earned —

even if there's a risk of forfeiture — so long as any forfeited bonuses are reallocated among the remaining employees in the pool rather than retained by the employer.

Under such a plan, an employer satisfies the all-events test because the *aggregate* bonus amount is fixed at the end of the year, even though amounts allocated to specific employees aren't determined until the payment date.

In reaching this result, the IRS has emphasized that the employer must:

1. Define the terms and conditions under which bonuses are paid,

2. Pay bonuses for services performed during the tax year,

3. Communicate the plan's general terms to employees when they become eligible and when the plan is changed,

4. Determine the minimum aggregate bonus amount either through a formula fixed before year end, or based on a board resolution or other corporate action taken before year end, and

5. Reallocate forfeited bonuses among other eligible employees.

Item 4 above is significant: It indicates that a bonus plan satisfies the all-events test if the minimum aggregate bonus is determined according to a *formula* that's fixed by year end. This allows employers to deduct performance-based bonuses tied to earnings or other financial benchmarks, even if the exact amount isn't determined until after year end, when the company's financial reports are prepared.

To ensure that bonuses are deductible this year, employers shouldn't retain any discretion to modify or cancel bonuses before the payment date or condition bonuses on approval by the board or a compensation committee after the end of the year.

Plan carefully

Designing a bonus plan that allows you to accelerate deductions into *this* year for bonuses paid *next* year can reduce your tax bill and boost your cash flow. To enjoy these benefits, work with us to ensure you satisfy the all-events test.