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View From McDermott: Accelerating Deductions for Compensation and Benefits if Corporate Tax Rates Are Reduced



BY STEPHEN PAVLICK

President-elect Trump proposes to reduce the maximum corporate income tax rate from 35% to 15%. While the effective date of any rate reduction is uncertain, it likely will not occur before 2018. Deductions claimed when tax rates are 35% are worth 20% more to the taxpayer than if the same deduction is claimed when rates are 15%. Thus, a deduction for a \$10 million pension contribution is worth an additional \$2 million if claimed in 2017 when the tax rate is 35% than if claimed in 2018 when the rate is 15%.

The article below discusses how bonus accruals, welfare benefits, and pension contributions that might be deducted in 2017 rather than 2018 without much, if any, in the way of additional costs or administrative burdens for the employer, and no adverse tax consequences for the employees/participants. Accelerating the deductions for these amounts will result in considerable savings if rates are reduced.

A. ACCELERATING THE DEDUCTIBILITY OF BONUSES EARNED IN YEAR ONE THAT ARE PAID ON OR BEFORE MARCH 15 OF YEAR TWO

BACKGROUND

Many corporations maintain annual bonus plans under which bonuses for a calendar year (“Year 1”) are

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paid on or before March 15 of the immediately following calendar year (“Year 2”) to employees who are actively employed on the payment date. The bonus amount can be either (i) based on an objective formula, e.g., tied to specific corporate benchmarks, or (ii) discretionary. In some cases, board or compensation committee approval in Year 2 is required even if the bonus amount is based on an objective factor, and active employment on the payment date is a condition to receipt of the bonus.

APPLICABLE LAW

Under the 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 (i) all the events have occurred that establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). The all events test is not met any earlier than when economic performance with respect to the item occurs. Code Section 461(h)(1). For liabilities arising from services provided to the taxpayer, economic performance occurs as the services are provided. Reg. § 1.461-4(d)(2).

To satisfy the all events test for determining when an item is incurred for federal income tax purposes, “a liability must be final and definite in amount, . . . must be fixed and absolute, . . . and must be unconditional.” *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 600 (1986). “The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligations will arise at some point in the future.” *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 34

(1988). “It is fundamental to the ‘all events’ test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established.” *United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987). See also Rev. Rul. 2007-3, 2007-1 C.B. 350. If there is any doubt that the liability will be paid, it may not be deducted until the liability becomes absolute. *Brown v. Helvering*, 291 U.S. 193, 201 (1934).

When a liability to pay a fixed amount of compensation to a group of service providers is involved, “it is the certainty of the liability which is of utmost importance in the ‘all events test’; and not necessarily either the certainty of the time over which payment will be made or the identity of the payees.” *Washington Post Co. v. U.S.*, 405 F.2d 1279 (Ct. Cl. 1969) at 1284. For more than 35 years the Service refused to follow *Washington Post*. See Rev. Rul. 76-345, 1976-2 C.B. 134. Finally, in Rev. Rul. 2011-29, 2011-49 I.R.B. 824, the Service revoked Rev. Rul. 76-345 and now concurs that “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.”

A deduction for deferred compensation is deferred until the taxable year of the employer in which an amount attributable to the employer’s contribution is includible in the income of the employees participating in the plan. Code Section 404(a)(5). A plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer’s taxable year to the extent that compensation is received after the 15th day of the third calendar month after the end of the employer’s taxable year in which the related services are rendered. Reg. § 1.404(b)-1T, Q&A 2(b)(1). Thus, to avoid the deduction deferral rule of Code Section 404(a)(5), an amount properly accrued in Year 1 must be actually paid no later than the 15th day of the third calendar month following the end of Year 1.

REQUIRED ACTIONS TO ACCELERATE DEDUCTIONS

Explicitly requiring an employee to remain in service until the payment date in Year 2, and/or delaying board or compensation committee approval of the bonus amount until Year 2, prevents satisfaction of the all events test in Year 1. Simply not paying bonuses, or paying reduced bonuses, to employees who terminate before such date, however, does not have that effect provided the corporation establishes an unconditional liability to the group of employees participating in the bonus plan before the close of its taxable year, which amount is communicated to the group before year end. There is no *de minimis* exception to the requirement that the liability become fixed before the close of the taxable year. Thus, the possibility that bonuses otherwise accrued during a calendar year might be forfeited to the taxpayer if an employee terminated during a brief period after the end of the calendar year and before the payment date prevents any portion of the liability from becoming fixed during the earlier calendar year. Chief Counsel Advice 201246029 (November 16, 2012).

An employer concerned about never paying bonuses in excess of the targeted amount might establish the year-end accrual in a conservative manner that may be

less than what the employer expects to pay. After the close of the taxable year, additional amounts could be awarded. Awards exceeding the amount of the liability established at the end of Year 1 should not adversely affect the deductibility of the Year 1 accrual, and would be deductible in Year 2. In the unlikely event that a substantial number of employees otherwise entitled to a bonus terminate before the payment date, it is conceivable that the bonuses paid to the remaining employees could exceed the amount the corporation otherwise expected to pay them.

The change in facts required to permit the deductibility of the bonus in Year 1, i.e., the establishment of an unconditional obligation before the end of Year 1 to pay a fixed amount to a group of employees, should obviate the need for a change in accounting method. See Rev. Rul. 2011-29, and Reg. § 1.446-1(e)(2)(ii)(b).

Since this strategy does not require any acceleration of payment, it will not result in any additional costs for the employer provided the amount accrued at year-end does not exceed the targeted bonus amount.

B. ACCELERATING THE DEDUCTIBILITY OF WELFARE BENEFIT CLAIMS THAT ARE INCURRED IN YEAR ONE BUT NOT PAID UNTIL YEAR TWO

BACKGROUND

Corporation maintains a self-funded health benefit plan for its active employees. Normally, it takes six to twelve weeks to process the payment of health claims. After claims are approved by a third party administrator, corporation makes payment directly to provider.

APPLICABLE LAW

In the absence of a contribution to a welfare benefit fund, a deduction is limited to claims that have been reported to the corporation before year end, and which are actually paid no later than two-and-one-half months after year end. See, *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987); Treas. Reg. § 1.404(b)-1T, Q&A-2. Contributions paid to a welfare benefit fund before year end are deductible to the extent of claims incurred but unpaid as of year-end. Code Sections 419 and 419A. This includes both benefit claims that are estimated to have been incurred but have not yet been reported at year end, as well as claims that have been reported but not yet paid. Also included are estimated administrative costs with respect to such claims. These estimates are typically based on historical patterns of claims paid in years subsequent to the years in which such claims were incurred. In the case of medical benefits, and absent an actuarial certification, contributions for incurred but unpaid claims cannot exceed 35% of the claims actually paid during the year. Code Section 419A(c)(5)(B)(ii). Similar pre-funding opportunities also exist for incurred but unpaid self-funded disability, SUB, severance, and death benefits.

REQUIRED ACTIONS TO ACCELERATE DEDUCTIONS

Establish a trust to which a contribution is made before year end that is equal to the incurred but unpaid welfare benefits. This requires an acceleration of the

cash payment that otherwise would have been made early in the following year.

C. ACCELERATING CONTRIBUTIONS TO DEFINED BENEFIT PLANS

BACKGROUND

Corporations that maintain defined benefit plans are required to make actuarially-determined periodic contributions to assure that the plan will have sufficient assets to pay all promised benefits. Few plans of major employers are currently fully funded. Additional tax savings arising from an acceleration of deductions may encourage some employers to increase their plans' funded status.

APPLICABLE LAW

Deductions for contributions are permitted up to the amount required to fully fund benefit liabilities. Code Sections 404(a)(1)(A) and 404(o). Depending on the size of the plan and its funded status, potential deduction could be substantial. After the Pension Protection Act of 2006, limitations applicable to corporations that maintain both defined contribution and defined benefit plans covered by the PBGC no longer apply. Code Section 404(a)(7)(C)(iv).

REQUIRED ACTIONS TO ACCELERATE DEDUCTIONS

An additional contribution is required to be made to the plan in order to claim a deduction. Contributions

can be made as late as the extended due date of the corporation's tax return for the year the deduction is claimed, *e.g.*, September 15, 2018, for calendar year 2017. Contributions may be made several years prior to when the contributions otherwise would have been required to meet the applicable funding requirements. Depending on the amount of the contribution and the corporation's financial status, it may be necessary to borrow all or a portion of any additional contribution to secure the permanent tax benefit. This would result in substituting a liability to the lending institution for the unfunded pension benefits currently recorded on the company's financial statements.

D. WHAT DOESN'T WORK

1. Ostensibly funding post-retirement health benefits under a VEBA and then using the amounts contributed for active medical benefits. *Parker Hannifin Corp. v. Commissioner*, 139 F.3d 1090 (6th Cir. 1998); *General Signal Corp. v. Commissioner*, 142 F.3d 546 (2nd Cir. 1998); *Square D Co. v. Commissioner*, 109 T.C. 200 (1997).

2. Treating 35% of claims incurred as an automatic safe harbor under Code Section 419A(c). *Square D Co. v. Commissioner*, 109 T.C. 200 (1997).

3. Accelerating the deduction for pre-tax and employer matching contributions under 401(k) plans. Rev. Rul. 90-105, 1990-2 C.B. 69, and later IRS guidance; Reg. § 1.401(k)-1(a)(3)(iii); 1.401(m)-1(a)(2)(iii).