Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Mark A. Erichsen, Revenue Agent
LMSB, Team 1529
from: Eric R. Skinner
Associate Area Counsel (Detroit)
(Large & Mid-Size Business)

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subject: - Vacation and Bonus Pay employment tax accrual

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

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Issue

Whether accrual basis taxpayers may be allowed to deduct employment taxes related to vacation/bonus pay accrued at the end of the tax year but not paid until the subsequent tax year.

Conclusion

Accrual basis taxpayers may be allowed to deduct employment taxes related to vacation/bonus pay accrued at the end of the tax year but not paid until the subsequent tax year. As discussed in more detail below, such taxpayers must satisfy the requirements of Section 461(h)(3) of the Internal Revenue Code and Treas. Reg. Section 1.461-1(a)(2)(i).

Facts

is an auto parts manufacturer and employs an overall accrual method of accounting.

currently deducts payroll taxes associated with year- end accrued vacation and bonus pay in the year before such taxes or associated compensation are actually paid.

Law and Analysis

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: (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. Treas. Reg. ' 1.461-1(a)(2)(i). The first two requirements, combined, are known as "the all events test." I.R.C. § 461(h).

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 1.461-4(g)(6) of the Treasury Regulations provides that if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it.

Section 1.461-5 provides the recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (1) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (2) economic performance occurs on or before the earlier of (a) the date that the taxpayer timely files a return (including extensions), or (b) the 15th day of the ninth calendar month after the close of the taxable year; (3) the liability is recurring in nature; and (4) either the amount of the liability is not material or accrual of the liability in the earlier year results in a better matching of the liability against the income to which it relates.

Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

Rev. Rul. 69-587, 69-2 C.B. 108 and the decision in Eastman Kodak v. U.S., 209 Ct.Cl. 365, 534 F.2d 252 (Ct. Cl. 1976) support the conclusion that employment taxes attributable to accrued bonuses and vacation pay of an accrual method

taxpayer/employer are deductible in the taxable year in which they are actually paid rather than the year the vacation/bonus pay is accrued.

In Rev. Rul. 69-587, the taxpayer, using the accrual method of accounting, maintained a vested, but unfunded, bonus and vacation pay plan for its employees. The taxpayer accrued and deducted FICA and FUTA (employment) taxes that it believed would be due as a result of the plan in the year in which it became irrevocably liable to its employees for the underlying bonuses and vacation pay. The taxpayer made the bonus payments and the employees took their vacations during the following year. The ruling determined it was not until the following year when the bonus and vacation payments are made that the fact of liability is established for FICA and FUTA taxes with respect to such bonuses and vacation pay.

Similarly, in Eastman Kodak Co. v. U. S. 209 Ct.Cl. 365, 534 F.2d 252, (Ct.Cl. 1976), the Court held the taxpayer could not deduct payroll (employment) taxes matched to accrued bonuses and vacation pay since, as regards the latter two items, the employer did not know, as of year end, whether each employee would be paid such compensation before the yearly ceiling on payroll taxes for the subsequent year had been reached.

Thus, in order for a taxpayer to properly deduct, in the current year, employment taxes related to accrued vacation/bonus pay which is actually paid in the subsequent year, it would have to meet the all events test and economic performance must have occurred with respect to the liability. Both the revenue ruling and court case noted above pre-date the effective date of the recurring item exception under Section 461(h)(3). The adoption of the recurring item exception together with the holdings in Rev. Rul. 69-587 and Eastman Kodak provide a framework for determining whether the taxpayer in the instant case should be allowed to deduct the employment taxes related to the accrued vacation and bonus pay if it establishes certain elements.

Section 461(h)(3) of the Internal Revenue Code (the "recurring item exception") provides that, notwithstanding the general rule of §461(h)(1), an item shall be treated as incurred during any taxable year if: 1) the all events test is met; 2) economic performance occurs within the shorter of 8 1/2 months or a reasonable period of time; 3) the item is recurring in nature and the taxpayer consistently treats the item as incurred in years where the all events test is met; and 4) either the item is not material or the accrual in the year when the all events test is met results in a more proper match against income than accruing when economic performance occurs.

In light of the recurring item exception above (which incorporates the all-events test), the taxpayer must be able to establish a number of facts before being allowed to currently deduct employment taxes related to vacation/bonus pay accrued at the end of the tax year but not paid until the subsequent tax year:

1. The taxpayer must establish that its liability for each type of underlying year-end compensation (to which the employment taxes relate) is fixed and the amount of the

liability can be determined with reasonable accuracy at year end - i.e. they satisfy the all events test under IRC 461. An analysis of this factor will require a rather detailed examination of the bonus and vacation plans of the taxpayer to determine its method for determining the employees' entitlement to either the bonus or vacation pay accrued. The taxpayer has to establish that under the respective plans or arrangements, the liability for the year end compensation is fixed and that the amount can be determined with reasonable accuracy (e.g. bonus based on a percentage of year-end sales where the sales figure is known (or could be determined) at year end;

2. The taxpayer must establish the accrued deduction for employment taxes will be limited to the taxes for year end compensation (that meets the all events test above) which is actually paid within 2 1/2 months of year end;

3. The taxpayer adopts the recurring item exception. This means the taxpayer consistently treats the item (which must be recurring in nature) as incurred in the years the all events test is met for the item; and

4. The taxpayer must not deduct any payroll taxes with respect to any employee whose pay could exceed the wage caps at the time the accrued wages are paid (i.e. within the 2 1/2 months after the close of the tax year). This will usually be limited to highly compensated employees because of the current wage cap.

Assuming the taxpayer can establish the above facts it may be allowed to deduct employment taxes related to vacation/bonus pay accrued at the end of the tax year but not paid until the subsequent tax year.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please contact the undersigned at 313-237-6426 if you have any questions regarding the foregoing.

Sincerely,

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(Heavy Manufacturing &
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By:_____
ERIC R. SKINNER
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