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AALU Bulletin No: 07-25

February 23, 2007

Subject: **IRS Allows Accrual-Method Taxpayers to Deduct FICA Contributions on Deferred Compensation Before the Compensation is Paid**

Major References: *Rev. Rul. 2007-12*

MDRT Information Retrieval Index Nos.: 2400.073

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

The Internal Revenue Service recently reversed a 38-year-old position respecting when accrual-basis taxpayers can deduct FICA taxes on deferred compensation. Under the new position, FICA taxes may be deductible before the year in which the deferred compensation is actually paid.

Under section 404(a)(5) of the Internal Revenue Code, deferred compensation (other than amounts from a qualified plan) is not deductible until the taxable year in which the amounts attributable to the compensation are includable in the gross income of the employee participating in the plan. This is the so-called "matching principal," which delays the employer's deduction until the employee takes the deferred compensation into income. Section 404(a)(5) also provides that any vacation pay that is treated as deferred compensation is deductible in the employer's taxable year that it is paid to the employee.

Employment taxes, however, are not subject to the same rules as the income tax. Under section 3121(v)(2), deferred compensation is generally includable in "wages" for purposes of FICA and FUTA taxes as of the later of the performance of services or the time when there is no longer a substantial risk of forfeiture of the right to the deferred compensation. Consequently, in the case of a vested deferred compensation payment, the relevant FICA taxes (and FUTA taxes, if any) will be payable when the services are performed -- not when the deferred compensation is actually paid, which could be much later.

In 1969 (in Rev. Rul. 69-587), the IRS concluded that an accrual-method taxpayer generally could not deduct payroll taxes payable with respect to bonuses and vacation pay that was accrued but unpaid at year-end until the taxable year in which the bonuses and vacation pay were paid. That position was subsequently modified in 1996 (in Rev. Rul. 96-51), when the Service concluded that an accrual-method employer could deduct, in year 1, its otherwise-deductible payroll taxes imposed on year-end wages properly accrued in year 1 but paid in year 2, provided the employer satisfied the otherwise-applicable accrual requirements. In that particular case, however, the year-end wages were paid within 2½ months after the close of the calendar year so they were not actually treated as deferred compensation for purposes of the deduction rules under section 404.

The question posed in Rev. Rul. 2007-12 is whether an accrual-method taxpayer can deduct its FICA and FUTA tax liabilities incurred in year 1 if the compensation to which the tax liability relates is deferred compensation that is not deductible under section 404 until year 2. For purposes of this analysis, the IRS assumed that the all-events test and the recurring-item exception of section 461 were satisfied.

The Revenue Service reviewed the three fold deductibility requirements for an accrual-method taxpayer:

1. all the events must have occurred that establish the fact of the liability;
2. the amount of the liability must be determinable with reasonable accuracy; and
3. economic performance must have occurred with respect to the liability.

In general, if the liability of a taxpayer arises out of the providing of services to that taxpayer by another person, the economic performance does not occur until the services are provided. In addition, economic performance generally does not occur until the amount is deductible under section 404 of the Code.

The same accrual rules provide a special rule for so-called "recurring items." Under the recurring-item exception, a liability is treated as incurred for a taxable year if several conditions are satisfied:

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 the taxpayer files its tax return for the taxable year; 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 taxable year results in better matching of the liability against the income to which it relates than would result from the accrual of the liability in the taxable year in which the economic performance occurs.

After going through this analysis, the IRS decided that the liability for payroll taxes does not represent compensation paid or accrued by an employer on account of any employee. As a consequence, section 404 does not control the deductibility of the employer's liability for payroll taxes even if the payroll tax liability relates to deferred compensation. Therefore, if the all-events test or the recurring-item

exception are otherwise satisfied, an accrual-basis taxpayer may treat its payroll tax liability as incurred in year 1, regardless of whether the compensation to which the liability relates is deferred compensation that is not deductible until year 2. In reaching this conclusion, the IRS revoked the 1969 ruling (Rev. Rul. 69-587) and modified the 1996 ruling (Rev. Rul. 96-51).

As a consequence of Rev. Rul. 2007-12, accrual-basis employers, that have delayed deducting FICA and FUTA taxes on deferred compensation until the year in which that compensation was deductible for income tax purposes, should consider seeking a change in method of accounting in order to deduct the FICA and FUTA taxes in the earlier year in which the all-events test (or the recurring-item exception) is satisfied. Rev. Rul. 2007-12 makes it clear that a change in this deduction method is a change in the method of accounting that requires approval of the IRS.

Any AALU member who wishes to obtain a copy of Rev. Rul. 2007-12 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email James Larsen at larsen@aalu.org and include a reference to this *Washington Report*.

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