

Abstract: Businesses may be familiar with the rule that permits them to deduct employee bonuses this year if they pay them to employees within 2½ months after the end of the tax year. It's an attractive year-end planning technique that lets a business enjoy a tax deduction this year while its employees needn't report the income until next year. It's important to understand the requirements, however, because these tax benefits aren't always available. This article provides a quick review.

Business tax planning

Can you deduct 2024 bonuses this year?

You may be familiar with the rule that permits a business to deduct employee bonuses this year if it pays them within 2½ months after the end of the tax year. It's an attractive year-end planning technique that benefits your business and your employees: You enjoy a tax deduction this year, while your employees needn't report the income until next year.

These tax benefits aren't always available, however, so it's important to understand the requirements. Here's a quick review.

Accrual-basis taxpayers only; no related parties

If your business uses the *cash* method of accounting, you must deduct bonuses in the year they're paid, even if they're earned in the previous year. To accelerate bonus deductions into this year, your business must be on the *accrual* method of accounting.

Favorable tax treatment is limited to bonuses paid to unrelated parties. For a corporation, a related party is an individual who owns more than 50% of the company. For S corporations, partnerships and limited liability companies, related parties include any of their shareholders, partners or members.

Fixed and determinable

Even if the first two requirements are met, you can't deduct a bonus this year unless it's fixed and determinable as of December 31. Generally, this means that:

- The recipient has earned the bonus,
- All events have taken place that establish the company's liability to pay it, and
- The amount of the bonus can be determined with reasonable accuracy.

Many companies get tripped up by the "fixed and determinable" requirement because their bonus plans condition payment on the recipient's continued employment through the payment date. If employees who leave the company before the payment date forfeit their bonuses, the company's liability isn't established by year end.

There may be a way to avoid this problem, however. Under IRS guidance, it's possible to deduct bonuses earned this year, even if there's a risk of forfeiture. The solution can be to use a properly designed bonus pool. For this strategy to work, the aggregate amount in the pool must be fixed by the end of the year. And, any forfeited bonuses must be reallocated among the remaining employees.

Handle with care

If you wish to accelerate deductions for bonuses paid next year, consult your CPA to make sure that you meet the requirements. It's critical to design your bonus plan carefully to avoid any language that suggests bonuses aren't fixed by the end of the year, such as retaining discretion to modify or cancel them or conditioning payment on board approval.

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