Deducting payroll taxes on accrued bonuses and vacation pay

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Does your company wait until after the end of the year to pay out year-end bonuses and vested vacation pay? If you use the accrual method of accounting for tax purposes, you may be eligible to deduct your share of payroll tax liabilities on that compensation in the year it is accrued, rather than the year it is paid. Typically, claiming a deduction for the taxes in the earlier tax year would be beneficial.

For many years, the IRS allowed accrual-method employers to deduct their liability for FICA (Social Security and Medicare) taxes and federal unemployment (FUTA) taxes on bonuses and vacation pay only in the tax year in which the compensation giving rise to the tax liability was actually paid.

For example: If a company's board approved $500,000 in bonuses on December 28 of Year 1 to be paid to employees for services provided during Year 1, and the bonuses were paid on January 5 of Year 2, the company could not deduct its liability for payroll taxes on the bonuses until Year 2.

However, the year in which to take the tax deduction was controversial.

A New Safe Harbor

The IRS has now resolved this uncertainty problem by providing a safe harbor accounting method to accrual-method employers, effective for tax years ending on or after December 31, 2007. If the safe harbor conditions are met, a business will qualify for the tax law's *recurring item* exception to the same-year-as-paid deductibility requirement.

The IRS has provided procedures for a business to obtain automatic consent for change to the safe harbor method. If you are interested in pursuing this opportunity, Baker Tilly can provide more information.

This article originally was featured in the *Baker Tilly Tax Strategist* electronic monthly newsletter, featuring hot topics, tax savings ideas, case studies, and other relevant information to help you navigate through the inevitable challenges that arise and capitalize on tax opportunities that come your way. Send an e-mail to tax@bakertilly.com with any questions or to subscribe to the newsletter.