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## Revenue Ruling 67-341

Advice has been requested whether deductions claimed by an employer under section 404(a) of the Internal Revenue Code of 1954 for contributions to an employees' qualified profit-sharing or stock bonus plan are affected in cases where it is concluded that an employee's total compensation for a taxable year is unreasonable or excessive.

Section 1.404(a)-1(b) of the Income Tax Regulations states, in part, that in order to be deductible under section 404(a) of the Code, contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or under section 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) of the Code only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on a trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) of the Code for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts of the particular case. See section 1.404(a)-(1)(b) of the regulations.

Compensation disallowed as unreasonable would not be considered an ordinary or necessary expense under section 162 or section 212 of the Code in the year paid or in any subsequent year. Accordingly, for the purpose of determining the amount of the allowable deduction under section 404(a) of the Code, the contribution paid must be adjusted for any amount which has been disallowed. Of course, the nondeferred compensation must also be adjusted for the amount disallowed for purposes of section 162 or section 212 of the Code. Furthermore, since such disallowed contribution does not constitute an ordinary and necessary business expense or an expense for the production of income in the year paid or any subsequent year, no carryover of the excessive contribution that is disallowed would be available under section 404(a) of the Code. However, where the plan requires or permits a reallocation of the disallowed contribution among the other employees in the plan, and the reallocation when made does not cause the contributions made on behalf of the other employees to exceed the allowable amount established in section 404(a)(3), the employer would be able to deduct in the taxable year in which his contribution was paid into the trust, the amount of the reallocated contribution under section 404(a). Where there is a reallocation which, together with the amounts already contributed to the plan on behalf of an employee for that taxable year, causes the contribution to exceed the allowable amount established in section 404(a)(3), a carryover will be available under section 404(a).

Although the Code and regulations require the disallowance of the excessive amount of the total nondeferred and deferred compensation, they are silent as to the manner in which the disallowed amount should be allocated between the deferred and the nondeferred compensation.

The continued qualification of most deferred compensation plans, under section 401(a) of the Code, may be affected by unreasonable compensation. Unless some adjustment is made, such as reallocation of the unreasonable amount to the other participants, the plan could become discriminatory since contributions or benefits in relation to compensation would be relatively greater for the individual unreasonably compensated than for rank-and-file employees.

It should be noted that there is no objection in permitting an employee to participate to the extent of reasonable compensation. Thus, after the appropriate reallocation is made, he may continue to participate in the plan on a nondiscriminatory basis.

Assuming the plan continues in a qualified status, any reasonable method may be used for adjusting deductions for contributions made by an employer to a trust under a stock bonus or profit-sharing plan. Where total compensation includes a bonus, but contributions are based only on basic compensation, two suggested methods are indicated, as shown below. These computations may also be used where contributions are based on total compensation, whether or not such compensation includes a bonus, but in such case the arithmetic results will be identical regardless of which computation is used.

Method 1: If it is determined that the total compensation (deferred and nondeferred) paid to an employee is unreasonable, both deferred and nondeferred compensation are adjusted proportionately.

Method 2: If it is determined that the total compensation (deferred and nondeferred) paid to an employee is unreasonable, the amount considered to be reasonable should include both the allowable deferred and nondeferred compensation. In a case where the employer has contributed 15 percent of participants' compensation under the plan, the total reasonable compensation would be considered to be 115 percent of the allowable nondeferred compensation. However, if a plan contains a contribution formula and contributions thereunder exceed or fall below 15 percent of participants' compensation in a particular year, the same method would be applied to allocate the reasonable compensation between deferred and nondeferred compensation. Thus, under a particular plan formula where contributions equal 20 percent of participants' compensation, the total reasonable compensation would be considered to be 120 percent of the allowable nondeferred compensation. (Assuming there are no carryovers from prior years, it must be kept in mind that a further adjustment would be necessary representing the difference between the 20 percent contribution based on the compensation determined to be reasonable and the statutory primary limitation of 15 percent of such compensation. This adjustment however would be available as a contribution carryover.) Similarly, the 115 percent would be reduced in cases where contributions by the employer are less than 15 percent of nondeferred compensation. The following is presented to illustrate the aforementioned methods.

An employee was paid \$20,000 basic compensation and bonuses in the amount of \$15,000. In addition, contributions were allocated to him under an approved profit-sharing plan in the amount of \$3,000. There were no carryovers allowable attributable to prior years and the employer's contributions amounted to 15 percent of basic compensation paid or accrued during the year in question. It is concluded that reasonable compensation for the employee is \$23,000. As a result, the total deduction for nondeferred and deferred compensation will be reduced by \$15,000.

Method 1: (Adjusted proportionately) \$3,000 (Deferred compensation of \$15,000 (unreasonable compensation) \$38,000 (Total deferred and nondeferred compensation) equals \$1,184.21 (Deferred compensation disallowed) \$35,000 (Nondeferred compensation) of \$15,000 (unreasonable compensation) \$38,000 (Total deferred and nondeferred compensation) equals \$13,815.79 (nondeferred compensation disallowed).

Method 2: The employer is considered to have contributed 15 percent of each participant's nondeferred compensation used under the plan. Therefore, the \$23,000 in the example represents 115 percent of the employee's allowable nondeferred compensation which is computed to be \$20,000. Participating in the plan to the same extent as the other employees, the employee would be entitled to an allocation of profit-sharing contributions to the extent of 15 percent of \$20,000, or \$3,000. Since this is the amount originally allocated to the employee, no adjustment to the deduction limitation under section 404(a)(3)(A) of the Code would be required.

However, in any case in which, after the reduction in the compensation base, there is disallowance of an amount solely because it exceeds 15 percent of the adjusted base, then such disallowed excess contribution would be available as a carryover under section 404(a)(3)(A) of the Code. To illustrate this, assume that an employer's contribution under a profit-sharing plan is based on a percentage of net profits without regard to the amount deductible in a given year under section 404(a). Assume further that a contribution of 10 percent of net profits amounts to 20 percent of compensation, and that the employer's contribution is allocated in the ratio of compensation. Thus, a particular employee whose nondeferred compensation for the year totaled \$100,000 received an allocation of \$20,000 of the profit-sharing contribution. However, reasonable compensation for this employee was determined to be \$110,000. In order to participate in the profit-sharing plan on the same basis as all other employees, the \$110,000 limitation would have to be considered to include a nondiscriminatory allocation under the profit-sharing plan. Consequently, using "Method 2" stated above, the amount of \$110,000 would represent 120 percent of the employee's allowable nondeferred compensation (\$91,667) and a nondiscriminatory allocation would be limited to \$18,333 (20 percent of \$91,667). However, the deduction limitation under section 404(a)(3)(A) would allow only 15 percent of the nondeferred compensation to be deducted in the current year. Thus, \$13,750 (15 percent of \$91,667) would be deductible and the excess of \$4,583 over the \$13,750 would be allowable as a contribution carryover for a subsequent year.