Bonus to Terminated Employee Contested but Still Deductible

By Robert W. Wood • Wood & Porter • San Francisco

Apart from certain government fines and penalties, litigation settlement payments made in the context of operating a trade or business seem to be rarely questioned. But as is so often the case, the interesting fringe fact patterns seem to arise in the context of closely held businesses.

Michael Winter was a shareholder and employee of an S corporation bank operating on the cash method of accounting. In 2002, he was awarded a $5.5 million five-year prepaid bonus. It was partially repayable if he quit or was fired for cause.

He was fired the same year, and the bank demanded a partial return of the bonus. On its 2002 tax return, the bank deducted $1.1 million, the portion of the bonus Winter earned in 2002. Winter claimed he never received a K-1.

However, he computed his income as if the bank had deducted the full $5.5 million. Winter therefore showed a pass-through loss of about $1.2 million on his 2002 personal return. The bank had actually reported $820,000 of income to Winter on a K-1. That meant there was a large $2 million mismatch.

Liability Contest

Winter argued the bank was entitled to deduct the unearned portion of the bonus as a contested liability for 2002. After all, he said, his termination effectively converted the prepaid bonus to compensation for his premature dismissal. The IRS countered that there was no contest at the time the deal was made. According to the IRS, it therefore could not qualify as a contested liability under Internal Revenue Code Section (“Code Sec.”) 461(f).

However, Winter had a fall-back position. He claimed that although he originally reported the full amount of the bonus as income in 2002, it was actually a loan. Don’t like the loan argument?

He argued in the alternative that the payment was an amount that, even though “bonused,” could not all be income. It failed one of the fundamental tests of taxability, he argued,

because he simply did not have unrestricted access to it.

Faced with this mess of contentions, the Tax Court analyzed Code Sec. 461(f). The court agreed with Winter that the bank was entitled to deduct the full bonus in 2002. After all, there was no dispute about the amount of the payment when it was made. Then, in November of 2002, Winter's termination for cause clearly established a contest within the meaning of Code Sec. 461(f).

There was, said the court, an "asserted liability" for purposes of Code Sec. 461(f). The bank *could have* deducted the entire amount if Winter had been fired without cause. That would mean Winter would be entitled to keep the money as separation pay under his employment agreement.

Unconditional Obligation to Pay?

The fact that the Tax Court concluded that the company could deduct the full bonus in 2002 had a corollary: It was all income to Winter in that year. True, he might have to repay the bonus if he quit or was fired for cause.

Yet Winter had no *unconditional* obligation to repay the bonus at the time he received it. The court analogized the bonus to a salary advance. It was conditioned on Winter's provision of future services to the bank. It was not accompanied by a note evidencing indebtedness.

This may sound unbalanced, but the court noted that Winter would presumably be entitled to an offsetting deduction under Code Sec. 162 or 1341 when any amount was repaid. Repayments by executives, as we have noted in the M&A TAX REPORT, don't always have an equitable tax result. [*See, e.g., Execs Who Forfeit Pay,* M&A TAX REP., May 2008, at 1.]

Finally, the court agreed with the IRS that penalties under Code Sec. 6662 were appropriate. Regardless of whether or not he had received a K-1, the Tax Court said he was plainly aware he *should* have received one. He failed to request a copy or otherwise disclose his inconsistent position.

Contested liability issues can often give rise to inconsistent tax positions by payors and payees. Watch them closely.

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