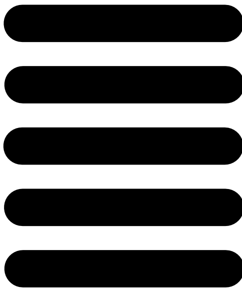

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# Execs Who Forfeit Pay

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

When an executive must repay compensation, the tax questions are fundamental:

- Does the Internal Revenue Code ("the Code") allow undoing a prior transaction?
- How does this square with the axiom of annual accounting, one of the underpinnings of our tax system?
- If you give back compensation, can you be made whole *via* a tax deduction?
- If a deduction is warranted, what is its timing and character?

Assume a disgraced executive received a $20 million cash bonus in 2006, on which state and federal income taxes, Social Security and other payroll taxes have been withheld. A court or administrative order may direct the repayment, or a contract provision may do so. If the executive returns it in 2008, does he give back only his net check after all those deductions?

Presumably not. The true payment to the executive was $20 million, or even more when you consider the employer's portion of payroll taxes. The taxes withheld are credited to the executive's income tax obligations and Social Security account, and it may be his problem to get them back. The company may offset tax amounts, but it is probably not obligated to.

It would be easy to address a cash bonus and giveback in the same year, but this seems rare. Normally, the executive has previously included the payment in income, is now returning it and wants to deduct it.

The choices may involve business expense deductions under Code Sec. 162, amending prior year returns, salary and bonus offsets, and deductions under Code Sec. 1341. As we'll see, the latter seems the best alternative, but it is not free from complexity.

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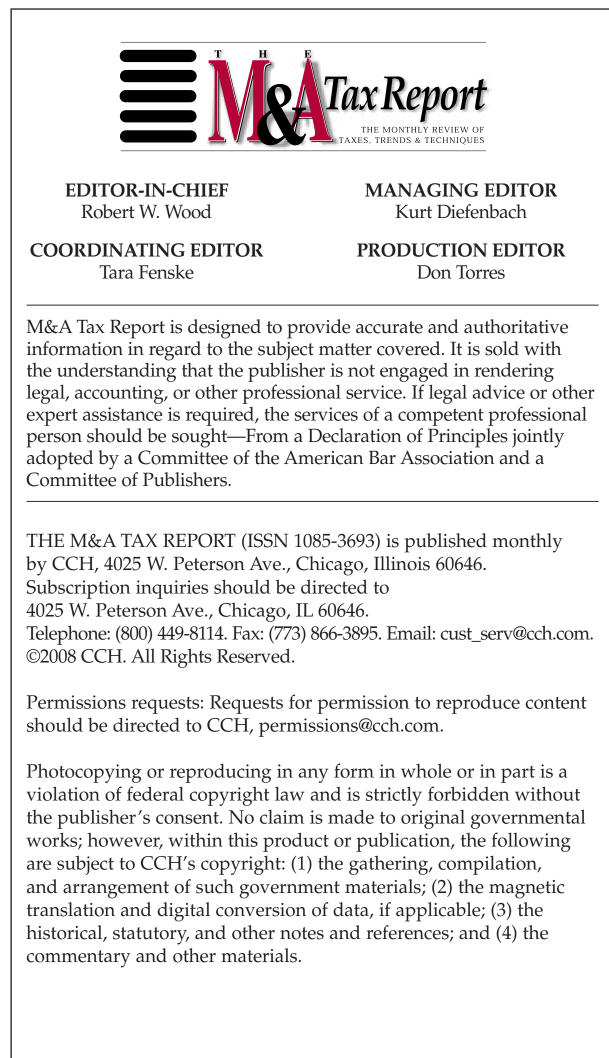
## Claim of Right Complexity

The claim of right doctrine requires us to pay tax in the year we received something under a claim of right, even if it is later determined the right was not absolute, and we must return it. If a taxpayer has free and unfettered use of funds from the time of receipt, the tax year of receipt is the appropriate time to fix the tax liability. The taxpayer should deduct a repayment in the year of repayment.

Code Sec. 1341 attempts to place the taxpayer back in the position he would have been in had he never received the income. Frequently, other deductions can be subject to limitations, phase outs, floors, *etc.* To claim a deduction under Code Sec. 1341, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to it. Plus, a deduction must be allowed under another Code section. Code Sec. 1341 is not a deduction-granting section.

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Finally, the taxpayer must learn in a subsequent year that he did not actually have an unrestricted right to the item. Courts have frequently interpreted this to mean that taxpayers were compelled by law to repay the amounts.

If a taxpayer meets the three tests of Code Sec. 1341, he can take his deduction under Code Sec. 1341.

## Setting Precedent

There is little authority regarding the claim of right doctrine applied to compensation repayments. Compensation is rarely repaid, and most of the extant authority involves closely held corporations and repayments by their controlling shareholders who are also either officers, directors or employees. However, one of the seminal cases involves an officer who only owned approximately 25 percent of the corporation. In *G. Blanton*, 46 TC 527, Dec. 28,054 (1966), *aff'd per curium*, CA-5, 67-2 USTC ¶9561, 379 F2d 558 (1967), the taxpayer repaid his corporate employer the portion of his director's fees which the IRS determined to be excessive.

He made the repayment pursuant to a contract (entered into after he received the fees, and possibly after the IRS deemed them to be excessive), which called for repayment of amounts the corporation could not deduct. The court disallowed a deduction under Code Sec. 1341, since the circumstances, terms and conditions surrounding the original payment indicated the taxpayer lacked an unrestricted right to such amount. Later courts have softened the rigid stance that the repayment must come from the circumstances, terms and conditions surrounding the original payment.

In *E. Van Cleave*, CA-6, 83-2 USTC ¶9620, 718 F2d 193 (1983), the board adopted a resolution in 1969 that payments to officers later disallowed by the IRS must be reimbursed by the officer. In addition to the bylaw change, the taxpayer entered into a separate contract with his controlled corporation that he would return his salary if the corporation could not deduct it. In 1974, Van Cleave received compensation which the IRS later deemed to be excessive.

Upon demand from the board, Van Cleave returned the excess salary. On his tax return, Van Cleave deducted the repayment under

Code Sec. 1341. The trial court characterized Van Cleave's return of his salary as "voluntary," since he controlled the corporation. The Sixth Circuit disagreed, allowing the deduction under Code Sec. 1341.

The appellate court held that the fact a restriction on a taxpayer's right to income does not arise until a year subsequent to receipt does not affect the availability of Code Sec. 1341. The court did not comment whether the bylaw requirement to return the salary, and the similar contract provisions were equally compelling.

Quite apart from lawsuits, contract giveback provisions are becoming common in executive compensation agreements. It may not be necessary for the repayment to be made pursuant to a judgment to be characterized as involuntary. The payment must be made under circumstances entitling someone to enforce the demand for payment by legal action. [*See* Rev. Rul. 58-456, 1958-2 CB 415.]

## Second Best

An executive who foregoes (or ignores) Code Sec. 1341 may find Code Sec. 162 unattractive. Code Sec. 162 provides a miscellaneous itemized deduction, subject to the two-percent adjusted gross income floor. Since deductions under Code Sec. 162 are below-the-line, they face phase out and AMT.

To be deductible, an expense must generally be (1) ordinary, (2) necessary and (3) a business expense. The regulations acknowledge that services performed as an employee can constitute a trade or business. [Reg. §1.162-17.] Numerous courts have come to the rescue of corporate officers, providing that their services also constitutes a trade or business.

To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. Determining whether an expense is necessary is far less clear. The key is whether the payment was voluntarily made or legally required.

For example, in *V.E. Oswald*, 49 TC 645, Dec. 28,879 (1968), the taxpayer's controlled corporation included in its original bylaws a requirement that any compensation not deductible by the corporation must be repaid. Later, when the taxpayer repaid the corporation the nondeductible amount, the court allowed the taxpayer's Code Sec. 162 deduction. Since the corporation's bylaws were enforceable, repayment was necessary.

In *J.G. Pahl*, 67 TC 286, Dec. 34,109 (1976), the taxpayer's controlled corporation paid him an excessive salary. The bylaws did not provide for repayment of nondeductible compensation, but the board later amended the bylaws to so provide. The court denied the taxpayer's deduction for salary paid prior to the amendment, but allowed a deduction for salary repaid after the amendment. Payments prior to the bylaw amendment were deemed voluntary.

In the brouhaha over public company compensation, just how pertinent these cases are is debatable. Almost all of this case law deals with controlled privately held corporations, where the majority shareholder was a director, officer or employee—in some cases, all three.

## Employment Taxes

FICA has two components: old-age, survivors and disability insurance ("OASDI"); and hospital insurance. Generally speaking, both employer and employee pay 6.2 percent of wages in OASDI, but only up to the maximum wage base (which for 2008 is $102,000). While both employer and employee pay hospital insurance of 1.45 percent of an employee's wages, there is no maximum wage base. Thus, the full $20 million bonus incurs the hospital insurance tax.

If after a bonus repayment, an executive's prior year salary is less than the OASDI maximum wage base, the executive would have overpaid both OASDI and hospital insurance. In the more likely scenario where the executive's post-repayment wages exceed the OASDI maximum wage base, the executive would not have overpaid any OASDI, but would have overpaid hospital insurance tax.

If a bonus is repaid within the statute of limitations, the company must presumably repay the executive for the employment tax overpayment or reduce his future employment tax withholding. [*See* Reg. §31.6413(a)-1(b)(1).] The company could then claim credit (on a subsequent employment tax filing) for overpaying its portion and the employee's portion. If the statute of limitations has expired, however, the company is presumably not required to repay an executive the overpaid employment tax. In addition, the company

could evidently not claim a credit for any overpaid employment tax.

## Amending Prior Year Returns

Amending a prior year return might seem to be the cleanest method to effectuate a bonus repayment. Generally, however, taxpayers can amend returns only within three years of filing the original return, or within two years of the date the tax was paid, whichever is later. Plus, amending a prior year return is generally allowed only to correct a mistake.

Here, an amendment would not seek to correct a mistake, but would be changing the *nature* of the prior bonus transaction, netting it with the current repayment. Since the executive originally received the income under a claim of right, and without restriction as to its disposition, the taxpayer probably cannot later amend his original return.

## Salary Reduction?

Another alternative may be for the company to reduce the executive's current year salary. Of course, this works only for current employees, and many repaying persons are *former* employees. Plus, it isn't clear if an offset would achieve the same public relations or legal effect. Although, there does not appear to be any direct authority disallowing this arrangement, the IRS might argue that the two transactions (a current salary and a repayment of a prior year's salary) must be reported separately.

## Conclusion

We may see more such pay give-backs, in settlements of lawsuits and in early-stage investigations, where issues of the voluntary versus mandatory character of the repayment are likely to arise.

Public outrage and litigation are probably far more frightening than the prospect of losing a tax deduction for returning compensation. Nevertheless, the tax cost to this kind of mismatch may add enormously to the executive's overall cost of a payback. Moreover, this is the kind of tax issue that one can imagine an otherwise sophisticated client not comprehending. The headaches an executive would face on having to give back money *plus* face tax disadvantages will be palpable.