Giving Back Bonuses: Easy; Getting Tax Deductions: Priceless

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The newspapers are full of stories about executives repaying bonuses. In fact, there are so many of them under discussion today that it is difficult to know who is repaying what and why. There are calls for supertaxation of bonuses, new caps on bonuses, mandatory bonus repayments, voluntary bonus repayments, and various combinations of those things. In a climate of near (but understandable) hysteria, few seem to be discussing tax law, which seems downright ironic.

Some feel-good news came when New York's Attorney General, Andrew Cuomo, announced that 15 of the top 20 recipients of AIG retention bonuses (about $50 million worth in all) have agreed to give back their bonuses.[1] Although press coverage isn't clear on how voluntary or compulsory that was, Cuomo's comments suggest that the givebacks were entirely voluntary. Interestingly, *The Wall Street Journal* noted that in making the decision whether to remit, some of those individuals were concerned about the potential tax implications of returning money received.[2] Tax practitioners won't find that surprising.

In fact, what is surprising is that amid all the hubbub, there's been so little mention of this issue. After all, much of the brouhaha started with the payment of bonuses that everyone knows are tax deductible. The biggest catalyst for the bonus repayment mess was the discovery that many companies on the receiving end of enormous government bailouts were, at around the same time, paying out bonuses to some of the same people who caused the problems requiring the bailout. Of course, the bailout money was all tax dollars.

There were even tax rules released by the IRS on the heels of the bailouts. The IRS issued rules (incredibly quickly, mind you, which is no mean feat for the IRS) addressing how bailed-out companies would be treated for purposes of net operating losses on the receipt of bailout money. And much of the focus on how to prevent this sort of thing from ever happening again has been centered on the tax code. We turn to the tax code, it seems, to change behavior.

With this considerable focus on the tax law, it seems a little strange that few appear to be considering exactly what happens from a federal income tax perspective when someone returns compensation they received. Like so much else in the tax law, it is a far more complex problem than one might think. Dollars in and dollars out sounds simple, but untangling the mess for the executives who return money is going to be a doozy.

Voluntary Payback

Whatever the factual setting, a repayment of cash compensation raises interesting and fundamental tax questions. For example, does the code allow the undoing of a prior transaction? If so, how does that square with annual accounting, which is one of the underpinnings of our tax system? If you give back compensation (voluntarily or not), can you be made whole via a tax deduction? If a deduction is warranted, what is its timing and character?

Suppose an executive received a $10 million cash bonus in 2008, on which state and federal income taxes have been withheld, along with Social Security and other payroll taxes. Suppose the executive gives it back in 2009, either voluntarily or under some kind of program. Does he just give back his net check after all those deductions?

That might seem a reasonable approach if the executive were repaying compensation, because that is all he received. But withheld income taxes were credited to his account with the IRS. If a court or administrative order directs the repayment or even if a repayment provision in a contract is triggered, the true payment to the executive was $10 million. However, the payment was more than that 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.

The easiest scenario to address is one in which the cash bonus and the giveback occur in the same year. That seems rare, however. The majority of bonus repayments do not occur in the year of payment. That means the repaying executive, whether he must return the entire bonus or only some net number after deductions, has a

[1]*See* Rappaport and Pleven, ''AIG Employees Will Return About $50 Million of Bonuses,'' *The Wall Street Journal*, Mar. 24, 2009, p. C1.

[2]*Id*.

tax problem. He has previously included in income (probably as wages) an amount he is now returning and wants to deduct.

It is probably necessary to know whether the repayment is voluntary. As we shall see, a repayment motivated by altruism, shame, or patriotism may be more admirable, but it may yield a bleaker tax outlook. An executive who gives back a bonus when a law, court order, or administrative decree requires it runs an easier tax gantlet, although even that does not guarantee a rosy (or even just) tax posture. For the most part, we'll assume the executive can make a case that he *had* to give back a bonus, although that may not be a reasonable assumption in some cases.

Claim of Right Issues

In considering the tax ramifications of paying back compensation, there are several possibilities. It may be possible for the payer to claim a deduction under section 1341 for restoring an amount held under claim of right. The claim of right doctrine requires a taxpayer to pay tax on an item of income in the year in which he received it under a claim of right, even if it is later determined that his right to the item was not absolute and that he is required to return it.[3] The rule is based on the proposition that because the taxpayer has the free and unfettered use of funds from the time of receipt, the tax year in which that receipt occurs is the appropriate time to fix the tax liability. That is a manifestation of the annual accounting principle on which our tax system is based.

The claim of right doctrine allows the taxpayer to deduct the repayment amount from his income in the year of repayment (as opposed to deducting the amount in a prior year). That result was mandated by the Supreme Court, because income and deductions are determined on an annual basis.[4] Of course, annual accounting often results in a mismatch. The taxpayer may benefit less from the deduction in the year of repayment than if he had been able to deduct the amount repaid in the year of receipt. That may be the case when the taxpayer was in a higher tax bracket in the year of receipt than in the year of repayment.

Theoretically, that sounds quite nice, but section 1341 is not simple. Under it, a taxpayer who previously reported income under a claim of right may be able to later deduct the repayment in a subsequent year (but only if the amount restored is greater than $3,000). A section 1341 deduction usually provides a better result than a deduction under other code sections because it attempts to place the taxpayer in the position he would have been in had he never received the income. Frequently, other deductions can be subject to limitations, phaseouts, floors, and so forth.

Taxpayers must meet several requirements to obtain a deduction under section 1341. First, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to the item. Do most executives today meet that first requirement? Presumably yes. When the now-tarnished bonuses were awarded and paid, the executives probably had no idea they might have to return them.

Second, a deduction must be allowed under another code section. Section 1341 is not a deduction-granting section.[5] As discussed in more detail below, executives embroiled in the current scandal may be allowed a deduction under section 162 as an ordinary and necessary business expense. If so, they would appear to meet this second requirement.

What Is Voluntary?

A third requirement for a deduction under section 1341 is that the taxpayer must learn in a subsequent year that he did not actually have an unrestricted right to the item. Courts have frequently interpreted that to mean that taxpayers were compelled by law to repay the amounts. In other words, the taxpayer's repayment must be involuntary. Here we return to the awkward question of just how and why an executive today returns a bonus.

If an executive is embarrassed by publicity or ashamed and gives back a bonus, is that involuntary? Probably not. If the executive faces pressure at work from a ''suggestion'' that feels almost mandatory, is that involuntary? Does it take legal process? What about threatened legal process that ends in a settlement?

There is a dearth of authority on arrangements of this sort. Clearly, anyone returning compensation would have an easier time from a tax perspective if they had actually been ordered to pay back the money. Legal compulsion seems an absolute standard. However, a settlement with execution of legal releases presumably operates in the same way as a judgment. It is simply unclear what else might suffice as ''involuntary.''

If a taxpayer meets the three tests of section 1341 and therefore qualifies for the deduction, he can obtain the superior benefits of section 1341, compared with the inferior deduction he would receive under the underlying code section (let's say section 162) on which the section 1341 deduction is based. The explanation for section 1341's superiority is that a non-section-1341 deduction in the year of repayment often will not reduce the taxpayer's tax liability by the amount paid as a result of the initial inclusion.

For example, if the taxpayer's tax rates are lower in the year of repayment than in the year of inclusion, the taxpayer would not derive a benefit from the deduction equivalent to the burden imposed by inclusion in the year of receipt. Part of section 1341's superiority stems from its providing the taxpayer the greater benefit of either deducting the repayment in the year of repayment or reducing his tax liability by taking a credit (in the year of repayment) for the amount of tax he could have avoided had he excluded the item from income in the year of inclusion. In addition, unlike an ordinary and necessary business expense deduction the executive might obtain under section 162, the deduction provided by section 1341 is not a miscellaneous itemized deduction.

[3] *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).
[4] *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969).
[5] *Id.*

Section 1341 can actually make a taxpayer whole, as if the prior transaction hadn't occurred. For example, in Rev. Rul. 58-456,[6] a corporation distributed excess mortgage payments to its shareholders, violating its corporate charter. Under threat of legal action, the shareholders later repaid the dividend and were able to restore their basis in their stock to the extent that the prior distribution affected their basis.

Suppose the taxpayer had a basis of $1,000 in his stock and received a distribution of $10,000 when the corporation had no earnings and profits. The first $1,000 would constitute a return of basis and the remaining $9,000 would constitute income. If the taxpayer were later required to repay the entire $10,000, only $9,000 could qualify as a deduction under section 1341 and the remaining $1,000 would constitute a restoration of the basis of the stock.

Setting Precedent

There is little authority regarding the application of the claim of right doctrine to repayments of compensation, perhaps because compensation has rarely been repaid. Most of the existing authority involves closely held private corporations and repayments by controlling shareholders who are also either officers, directors, or employees.

However, one of the seminal cases involves a corporate officer who owned only about 25 percent of the corporation. In *Blanton v. Commissioner*,[7] the taxpayer repaid his corporate employer a portion of his director's fees that the IRS had determined to be excessive. The taxpayer made the repayment under a contract (entered into after he received the fees and possibly after the IRS deemed them to be excessive) that called for the repayment of amounts for which the corporation could not obtain a deduction. That kind of savings clause is often triggered by golden parachute payments, so the executive has to give back the portion of any payment that triggers the double whammy of nondeductibility and the excise tax on excess parachute payments. However, savings clauses are cropping up in other contract provisions as well.

According to the court in *Blanton*, for purposes of obtaining a deduction by restoring amounts held under a claim of right, it was irrelevant whether the taxpayer was legally bound by the later contract to return the salary. Furthermore, it was irrelevant whether the taxpayer and the corporation entered into the contract before or after the start of the IRS audit. Under the claim of right doctrine, the requisite lack of an unrestricted right to an item of income must arise out of the circumstances, terms, and conditions of the *original* payment. It cannot arise from a subsequent agreement.

Thus, the *Blanton* court disallowed a deduction under section 1341 because the circumstances, terms, and conditions surrounding the original payment did not reflect the fact that the taxpayer lacked an unrestricted right to that amount. Later courts have softened the rigid stance that the repayment must come from the circumstances, terms, and conditions surrounding the original payment. Indeed, a deduction for restoring an amount held under claim of right may be possible if, before the IRS disallows the corporate deduction, the corporation's board enacts a resolution requiring repayment if the corporation cannot obtain a deduction and the taxpayer executes an agreement to reimburse it.[8]

In *Van Cleeves v. United States*, the board adopted a bylaw 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 requiring him to return his salary if the corporation could not deduct it. In 1974 Van Cleeves received compensation that the IRS later deemed excessive.

On demand from the board of directors, Van Cleeves returned the portion of his salary that the corporation could not deduct. On his tax return, Van Cleeves deducted the repayment under section 1341. Because he was in a higher tax bracket in the year of repayment, section 1341 (versus section 162) had a material effect.

The IRS contested the application of section 1341, and the trial court agreed with the Service, characterizing Van Cleeves's return of his salary as voluntary. Because Van Cleeves controlled the corporation, the power to enforce and compel repayment was entirely in his hands. The court saw no sound policy in allowing this deduction, because there would be no downside to a taxpayer who received an excessive salary if there was a preexisting requirement to repay the nondeductible portion. The Sixth Circuit disagreed, however, and allowed the taxpayer's deduction under section 1341.

The appellate court held that the fact that a restriction on a taxpayer's right to income does not arise until a year after the time of receipt does not affect the availability of a section 1341 tax adjustment. The court expressly noted that Congress designed section 1341 to alleviate that problem because a deduction from another code section (aside from section 1341) may leave the taxpayer less than whole.

Interestingly, the court did not comment on whether the requirements to return the salary imposed by the bylaws and by the contract between the corporation and the officer were equally compelling. The court didn't say whether one alone was sufficient, or, if so, which one. Careful practice suggests providing for repayment both in organizational documents (such as bylaws) and in employment and consulting contracts. A payment that is not supported by those provisions and is truly voluntary may be problematic.

Out of Luck?

Meeting the requirement that the repayment must be involuntary may be easy with a court or administrative order, or perhaps even in a bitterly negotiated settlement.

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[6] 1958-2 C.B. 415.

[7] *Blanton v. Commissioner*, 46 T.C. 527 (1966), *aff'd per curiam*, 379 F.2d 558 (5th Cir. 1967).

[8] *Van Cleeves v. United States*, 718 F.2d 193 (6th Cir. 1983).

But there are many possibilities under which a repayment may be advisable. Even aside from lawsuits, giveback provisions are becoming common in executive compensation agreements, and the current economic and political climate is unheralded.

In any case, the focus on a legal mandate suggests an ironic result. A fired executive could obtain a deduction under the claim of right doctrine if he loses a legal battle and has to pay. A more altruistic executive who gives back the money because it's the right thing to do might not be able to obtain a deduction. Of course, it may not be necessary for the repayment to be made under a judgment to be characterized as involuntary.[9]

However, the payment must be made under circumstances entitling someone to enforce the demand for payment by legal action in the absence of compliance. In Rev. Rul. 58-456, the preferred shareholder (who was the Commissioner of the Federal Housing Administration) could, under the corporation's charter, enforce the return of a dividend on the common stock. Five years after the dividend, on demand by the preferred shareholder, the common shareholders returned the dividend and were able to deduct the payment under section 1341.

Second Best

Let's suppose there is no compulsory repayment. In lieu of obtaining a deduction for restoring amounts previously received under a claim of right, the next best thing would be an ordinary and necessary business expense deduction under section 162. As compared with section 1341, section 162 provides only a current-year deduction and does not necessarily make the taxpayer whole. Section 162 provides only a miscellaneous itemized deduction, subject to the 2 percent adjusted gross income floor. Worse still, because deductions under section 162 are below the line, the deduction is subject to phaseout and the taxpayer may face the alternative minimum tax.

Of course, it is axiomatic that section 162 provides a deduction for ordinary and necessary business expenses. While section 162 has almost infinite nuances, generally, to be deductible, an expense must be ordinary, necessary, and a business expense.

The requirement that the bonus repayment is a business expense merits examination. Although there is no statutory or regulatory definition of what constitutes a business expense for an executive, the regulations acknowledge that services performed as an employee can constitute a trade or business.[10] Some courts have come to the rescue of corporate officers, providing that their services also constitute a trade or business. But it is unclear whether a repayment of compensation could remotely further that business.

To be deductible, a bonus repayment would also have to be ordinary. The determination whether an expense is ordinary depends on the facts and circumstances of the particular taxpayer. The Supreme Court noted over 75 years ago that whether an expense is ordinary is determined by its time, place, and circumstance.[11] Generally speaking, an expense is ordinary if a business would commonly incur it in the particular circumstances involved.

To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. A once-in-a-lifetime piece of litigation does not fail to be ordinary just because it is unusual, unexpected, or unlikely to reoccur. If a company is suing a former executive for fraudulent financial statement manipulation, it would seem that a one-time payment by other executives to bring prior bonuses in line with restated financial statements would be an ordinary expense.

The determination whether an expense is necessary is far less clear. The key to the necessary determination is whether the payment was voluntarily made or legally required.[12] A voluntary repayment of compensation in a subsequent tax year does not allow the taxpayer to take a section 162 deduction. In *Blanton*,[13] the IRS audited the taxpayer in 1963 regarding salary received in 1959 through 1961. Although Blanton had a contract to repay any portion of his salary that was not allowed as a deduction to the corporation, the court determined that his repayment contract was entered into no earlier than 1962.

In rejecting Blanton's section 162 deduction, the court said there was nothing in the record to establish that the repayment rendered the taxpayer any business benefit or was in any sense ordinary and necessary to his position at the company. Unfortunately, the court's opinion regarding the section 162 deduction is contained in precisely one sentence (unlike its lengthy section 1341 discussion noted above). Over time, other courts have expanded on *Blanton*'s laconic analysis.

In *United States v. Simon*,[14] on facts substantially similar to *Blanton*, the taxpayer did make his contract with his controlled corporation retroactive. Not surprisingly, the court did not find that additional fact convincing because the agreement was still entered into after the year in which the original salary had been paid. Indeed, the court found no business purpose, only tax advantages, in the retroactive nature of the contract. When an executive gives back compensation, there should surely be some business purpose, not a tax incentive.

The situation seems markedly different when a preexisting legal obligation requires the taxpayer to return the money. For example, in *Oswald v. Commissioner*,[15] 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 section 162 deduction because the corporation's bylaws were enforceable and repayment was necessary.

[9] *See* Rev. Rul 58-456, 1958-2 C.B. 415.
[10] Reg. section 1.162-17.
[11] *Welch v. Helvering*, 290 U.S. 111 (1933).
[12] *See* Rev. Rul. 69-115, 1969-1 C.B. 50.
[13] *Blanton*, 46 T.C. 527.
[14] 281 F.2d 520 (6th Cir. 1960).
[15] 49 T.C. 645 (1968).

In rejecting the IRS's argument, the court noted that the repayment bylaw served a valid business purpose, which was to help the company pay its increased tax bill caused by the denial of the compensation deduction. The purpose of the repayment bylaw was not to provide the taxpayer a deduction. A deduction, if allowed, reduces the taxpayer's tax.

Yet no one would argue that the taxpayer would be better off financially if he did not have to repay the corporation. The rationale of the courts in this line of cases becomes even clearer in *Pahl v. Commissioner*.[16] In *Pahl*, the taxpayer's controlled corporation paid the taxpayer an excessive salary. The original bylaws did not provide for repayment of nondeductible compensation, but the board of directors later amended the bylaws to so provide.

Although the board enacted the amendment before being audited, the amendment was made in the middle of a tax year that was later audited. Not surprisingly, the court denied the taxpayer's deduction for salary repaid before the amendment but allowed a deduction for salary repaid after the amendment. Payments made before the bylaw amendment were deemed to be voluntary.

In the brouhaha over public company compensation, just how pertinent those cases are is debatable. Almost all of that case law deals with controlled privately held corporations in which the majority shareholder was either a director, officer, or employee (or in some cases, all three). There don't seem to be any cases in which the director, officer, or employee was not a significant or majority shareholder. In that closely held context, a latent issue is whether the excessive compensation is really a disguised dividend.

Employment Taxes

Repayment of a bonus on which an executive (and the company) have already paid employment taxes makes it possible that the executive and the company will end up paying extra employment taxes.[17] FICA has two components: Old Age, Survivors, and Disability Insurance and hospital insurance. Generally speaking, both the employer and the employee pay 6.2 percent of an employee's wages in OASDI, but only up to the maximum wage base, which for 2008 was $102,000 and for 2009 is $106,800. Neither employers nor employees pay OASDI on wages in excess of the maximum wage base. Although both an employer and employee pay the hospital insurance at 1.45 percent of an employee's wages, there is no maximum wage base.

Thus, a $10 million bonus incurs the hospital insurance tax. If after a bonus repayment an executive's prior year salary were less than the OASDI maximum wage base, the executive would have overpaid both OASDI and the hospital insurance. In the more likely scenario in which the executive's post-repayment wages exceed the OASDI maximum wage base, the executive would not have overpaid OASDI, but would still have overpaid the hospital insurance.

It is possible for an executive to be made whole regarding the overpayment of a prior year's employment tax. For example, if a bonus is repaid within the statute of limitations, the company must either repay the executive for the employment tax overpayment or reduce his future employment tax withholding.[18] The company would then be able to claim a credit on a subsequent employment tax return for overpayment of both its portion and the employee's portion of the prior overpayment. However, if the statute of limitations has expired (unlikely in the current bonus scandals), it would seem that the company would not be required to repay an executive for the overpaid employment tax. Also, the company could evidently not claim a credit for any overpaid employment tax. In that scenario, the executive could get stuck with paying employment tax on the returned bonus.

Amending Prior-Year Returns

Amending a prior-year return might appear to be the cleanest method to effectuate a bonus repayment and perhaps entirely avoid the issues surrounding a later deduction. However, the IRS generally will not allow taxpayers to amend returns under repayment circumstances such as these.[19]

Amending a prior-year return is generally allowed only to correct a mistake on that return. Here an amendment would not seek to correct a mistake. Instead, it would be changing the nature of the prior bonus transaction by netting it with the current repayment transaction.

Netting across several tax years goes against our tax system's annual accounting concept and goes to the heart of the claim of right doctrine. Because the executive originally received the income under a claim of right and without restriction as to its disposition, he cannot later amend his original return.

Salary Reduction?

Another potential method to effectuate a repayment would be for the company to reduce the executive's current-year salary. Of course, that works only for current employees, and many repaying persons may be *former* executives. Besides, the math may not work if the executive's salary is $500,000 and $10 million needs to be returned. Plus, it isn't clear if an executive's giveback would achieve the same public relations coup (or the same legal effect) if he agrees to an offsetting salary reduction, even though simple math suggests that he has, in fact, paid the money back.

As with amending a prior-year return, the salary reduction method appears to avoid some of the sticky issues associated with repayment. There does not appear to be any direct authority disallowing that arrangement, although it does seem to circumvent much of the above discussion. The IRS might argue that in fact two transactions (a current salary and a repayment of a prior year's

[16] 67 T.C. 286 (1976).

[17] *See* Service Center Advice 1998026 and Rev. Rul. 79-311, 1979-2 C.B. 25.

[18] Reg. section 31.6413(a)-1(b)(1).

[19] *See United States v. Lewis*, 340 U.S. 590 (1951).

salary) are being netted, and each must be reported separately.[20] However, it isn't yet clear how that particular possibility for handling executive paybacks will play out.

Conclusion

The pressures of public opinion and litigation are probably far more frightening than the prospect of losing a tax deduction for having to return compensation. Still, the tax impact of that kind of mismatch adds enormously to the executive's overall cost of the payback. It is always puzzling when the tax treatment of a transaction seems at odds with its economics.

Indeed, on a fundamental level, this is the type of tax issue one can imagine an otherwise sophisticated client not understanding at all. The headaches faced by an executive from not only having to give back a bonus, but also from finding he's been tax disadvantaged, would be palpable. And the precise details of the repayment, whether prompted by law, regulation, public outrage, or shareholder outrage — or by an executive's general sense that it's the right thing to do — are going to matter.

Whatever the tax result, we may see more such pay givebacks, not only in settlements of lawsuits, but perhaps also in more early-stage investigations. We are also seeing overtly voluntary payments in which issues of the voluntary versus mandatory character of the repayment are likely to arise.

Fortunately, in our hurly-burly world, most of the bonus flap is occurring at a rapid pace. That this drama is unfolding over several weeks, rather than several years, may portend smaller tax problems for the executives involved. Still, there are surely at least some tax year mismatches (monies paid in 2008 were repaid in 2009). Tax returns may already have been filed. Moreover, there are clearly some "voluntary" payments being made, at least under the IRS's traditional view of what is and is not voluntary.

Of course, it's quite possible that I'm overreacting to this and that everyone has this issue solved. Indeed, it's also quite possible that Congress will dash off a new tweak to the Spartan tax code to ensure there are no tax laws standing in the way of bonus givebacks. If that occurs, I've been considering several suggestions for titles to such a law. My current favorite is the American Patriotism Tax-Neutral Pay Your Fair Share Bonus Giveback for the Good of America Act.

[20] *Supra* note 17.