

# Goldman Sachs Pay Clawbacks Raise Some Thorny Tax Issues

By Robert W. Wood

If you receive a bonus and have to return it, how are taxes handled? Do you just return your net take home pay, or do you have to get money back from the IRS and the California FTB too? After all, when taxes are withheld from your paycheck, they are credited to your Social Security Number with the IRS and FTB. These and other tough questions come up when a company requires a refund.

The latest instance involves Goldman Sachs, which is paying about \$2.9 billion to settle its role in the 1MDB scandal. The settlement was accompanied by news that the firm will claw back millions from top executives. The massive settlement with U.S. authorities is over Goldman's role in which a \$6.5 billion Malaysian investment fund was looted. Most people don't think about tax issues first, but there are plenty here.

First, before we get to the pay clawbacks, can Goldman write off the settlement money on its taxes? Paying any legal settlement is always a little less bitter for a defendant if they can write off the settlement on their taxes. Conversely, if they can't deduct it, it is much more painful.

How about fines? For many decades, Section 162(f) of the tax code has prohibited deducting any fine or similar penalty paid to a government for the violation of any law. That includes criminal and civil penalties, as well as sums paid to settle potential liability for a fine. This sounds absolute, but the law was riddled with exceptions. Some of those exceptions were eliminated in 2018, when the law was tightened materially.

But some wiggle room remains, and many defendants can figure out a way to claim tax benefits. For example, payments of restitution can often be deducted. Even so, I'm guessing that Goldman cannot deduct this one, which makes the payment that much more painful. These days, some government settlement agreements include an express agreement that no tax deduction will be claimed or that only a specific portion will be deducted.

How about taxes on the money from execs? A fraction of the money comes out of a claw back or pay cut totaling \$174 million in compensation from current and former employees, including CEO David Solomon and former CEO Lloyd Blankfein over the 1MDB scandal. Other pay clawbacks after a scandal include Wells Fargo, which in 2017 clawed back \$136 million from its former CEO and another executive over fake accounts. In 2007, a former UnitedHealth Group executive William McGuire had to give back \$618 million over claims of backdated stock options.

So how do pay clawbacks get treated with the IRS? Reducing pay that has not yet been made is easy. The exec simply is paid less, and the taxes follow with reporting of the actual amount paid on the employee's IRS Form W-2 for the year. But unwinding and returning pay that was *already* awarded is tougher. If you still have time during the same tax

year, adjustments can be made, and it can work out fine, assuming the numbers line up.

But how about prior tax years? Say you get a payroll check for \$100,000, of which your take home pay after taxes is \$60,000. Then, you are ordered to return it. Do you owe \$100,000, \$60,000, or some other amount? Can you get tax money back from the IRS? And what about state taxes and Social Security? The answer can depend on timing and many other variables. But timing and the legal background for the giveback are big factors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203) expanded SEC regulatory authority. Paybacks can be required even when directors and officers had no knowledge of wrongdoing. Section 304 of the Sarbanes-Oxley Act also has a clawback remedy. There are many clawbacks via lawsuits, and in other contexts, as is occurring with Goldman Sachs GS -1.6%.

In general, the IRS doesn't allow you to undo a prior transaction as if it never occurred. Rescission is sometimes possible where everything occurs (including the giveback) in the same tax year. In most cases, the giveback happens in a later tax year. Usually you can't just amend your prior year tax return either. Amending a prior tax return is generally allowed only to correct a mistake.

A pay giveback may not be a 'mistake,' since you were entitled to the pay when you received it. Besides, you can amend tax returns only within three years of filing the original return, or within two years of the date the tax was paid, whichever is later. But, you can surely claim a business expense deduction, right? Maybe, but usually it would only be a miscellaneous itemized deduction, subject to the 2% adjusted gross income floor and alternative minimum tax.

Even worse, miscellaneous itemized deductions were eliminated for 2018 through 2025 tax years, and don't come back into the law until 2026. Besides the payroll tax problem is thorny. If you are lucky, your company could agree to reduce your *current* year salary. Yet, this works only for *current* employees, and many repaying persons are former employees. Besides, it isn't clear if an offset would achieve the same public relations or legal effect as a real current payback.

For all of these reasons, most people in this unenviable position end up claiming an odd kind of tax refund under Section 1341 of the tax code. It embodies the "claim of right" doctrine, and attempts to place the taxpayer back in the position he would have been in had he never received the income. To claim a deduction under Section 1341, the taxpayer must have included money in income in the prior year because he had an unrestricted right to it then.

The taxpayer must learn in a later year that he did not have an unrestricted right to it after all (i.e., he has to give it back). But the nuances of these rules are not simple, nor are the mechanics. And there are frequent problems in application, and in the IRS reaction to it when it sees this on a tax return. There's also the question of voluntary vs. mandatory

givebacks. Why should it matter if you are forced to hand over the money, rather than deciding it's the right thing to do?

Perhaps it shouldn't, but the IRS cares. If you are being urged to give back pay but not required to, it isn't clear how these rules apply. The clearest case for getting your tax refund is you had to give it back. In short, for anyone in the situation, the tax headaches one will face on having to give back money can be palpable. Even so, when a highly paid executive has to return some pay, many people may not have much sympathy.

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