



Robert W. Wood

THE TAX LAWYER

TAXES 04/17/23

If You Have To Repay Compensation, Will IRS Refund The Taxes?



With all the failed companies and pay disputes, orders to repay compensation are more common than you might think. Sometimes, it is simply a signing bonus that you did not earn because it was conditioned on you staying with your employer for a minimum period. But there may be other reasons for

returning pay too, such as legal violations. How pay clawbacks are treated by the IRS varies with timing and other details.

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 calendar 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 clawbacks via lawsuits and in other contexts.

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, people in this unenviable position may 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).

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. If you are being *urged* to give back pay but not *required* to, it isn't clear how these rules apply. 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.

Check out my [website](#).