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More Wells Fargo Pay Clawbacks Over Fake Accounts Bring Tax Pain

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In the wake of its fake account scandal, Wells Fargo installed a new chief executive, reformed its sales incentives, and clawed back more than $60 million in stock awards from executives. Now, following an internal investigation revealing that improper sales practices go all the way back to 2002, Wells Fargo is clawing back another $75 million, and retroactively firing Carrie Tolstedt. She was the former head of the unit in charge of the unauthorized sales. A 113-page report makes the scandal look even worse, and helps explain the new claw back. Claw backs of pay can be dramatic, and send a big message that Wells Fargo is contrite and taking action.

Yet, at this time of year particularly, it's appropriate to wonder about the difficult tax issues any unwinding can present. In the case of the unvested options that were recouped from Mr. Stumpf ($41 million) and Ms. Tolstedt ($19 million), the clawbacks were easier. To start, these were mostly unvested options, so they were not really pay yet, at least not in the traditional sense. Tax wise, that makes them vastly easier to undo than if Wells Fargo had issued a payroll check and had to get it back.

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 Wells Fargo. In general, the IRS doesn't allow you to undo a prior transaction as if it never occurred. Rescission is sometimes possible, but only if 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. Plus, there is phase out and alternative minimum tax, both of which can mean extra taxes. And 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. 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.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.