

Repaying Compensation to Employer? How to Recover Withheld Taxes

By Robert W. Wood

Repaying compensation is generally not something done voluntarily. Sure, a CEO may trumpet willingness to slash his future salary to \$1, usually with a less publicized deal to tie boatloads of compensation to equity and stock price performance. However, anytime that an employee is paid compensation with taxes withheld that are paid over to the IRS, and then later is saddled with an obligation to repay some or all of it, repaying the compensation raises awkward tax issues.

The timing certainly matters, and it can make the situation better or worse tax-wise. If you have to give back pay, the best circumstance is if you make the give-back during the same year you received it. Say you receive a \$20,000 bonus in July, but learn in November you have to pay it back. If you are lucky enough to be expecting \$20,000 in salary and bonus before the end of the year, you could say that your "repayment" will be in the form of forgoing \$20,000 of other compensation that you were about to receive.

If you still have time during the calendar year, adjustments can be made and it can work out fine tax-wise, assuming that the numbers line up. The employee is simply paid less, and the taxes follow with reporting of the actual amount paid on the employee's IRS Form W-2 for the year. That is the cleanest and simplest of transactions, raising no tax complexities whatsoever. But how likely is this same-year scenario to play out in real life? Not very likely in my experience.

In most cases, by the time there is a pay-back request or mandate, it is another tax year. In fact, it may even be several years later, which complicates the tax issues. Indeed, it may even occur more than three years after the initial payment. Tax years are generally closed, with no refund or amendment possible, after three years have passed from the original tax return filing.

Whether the repayment occurs one or two years after the initial payment, or many, is there ever a way to recoup the taxes paid on the money that must be returned? There often is, but since this is about taxes, it is complicated. First, let's consider how the issue arises. With 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. Think about the mechanics.

Say you get a payroll check for \$100,000, of which your take home pay after taxes is \$65,000. Then, you are ordered to return it. Do you owe \$100,000, \$65,000, 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 pay 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 can also be clawbacks via lawsuits and in other contexts.

In general, the IRS does not allow you to undo a prior transaction as if it never occurred. Rescission may be possible as a legal remedy in some contexts, but even if rescission is granted as a legal remedy, the IRS generally does not recognize rescission with respect to taxes unless everything occurs (including the giveback) in the same tax year. As noted, in most cases, the giveback happens in a later tax year. Usually, you cannot just amend your prior year tax return to account for a later event either.

Amending a prior tax return is generally allowed only to correct a mistake, but not to reflect events that occurred later. A pay giveback is not a mistake or error with your tax return, 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.

This tax puzzle might lead you to ask whether you can claim a business expense deduction for returning the pay. Historically, that was sometimes possible, but deductions were usually limited to miscellaneous itemized deductions. That meant they were subject to a 2% adjusted gross income floor and alternative minimum tax that could drastically cut the effectiveness of the deduction.

In any event, since 2018, miscellaneous itemized deductions were eliminated by the tax Code. The recently passed One Big Beautiful Bill made that elimination permanent.

Moreover, the payroll tax problem if returning compensation is thorny. Even if the initial pay and the repayment occur in different tax years, one idea some executives have used is to ask the company to reduce their *current* year salary and bonus to reflect the economics of the repayment.

After all, cash is fungible. Of course, even if this works out on the numbers, it would be a viable workaround only for *current* employees, and many persons who are in the awkward repayment situation 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 these reasons, people in this unenviable position may end up claiming an unusual and complex 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 in the first place. 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 in my experience. If significant dollars are involved, the deduction is unusual enough that there may be an IRS audit too. Among the many issues that can be examined is the question of whether it is a voluntary or mandatory giveback. The tax rules are designed to apply when you are required (by law, by a legal settlement agreement, etc.) to pay back the money. If you are being *urged* to give back pay but not *required* to, it isn't clear how or if these rules apply.

The bottom line is that the tax headaches one can face on having to give back money can be palpable. Of course, depending on the context, the person repaying the compensation may not have any choice, and they may have bigger problems than the tax dollars. On the positive side, it is often possible to put the person economically back in the tax position they would have been in had they never been awarded the pay in the first place. It just takes patience, finesse, and a little luck.

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