

Big Board Payback

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter, in San Francisco (<http://www.woodporter.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2006 Update), available at <http://www.damageawards.org>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

The recent news that former New York Stock Exchange (NYSE) Chair Dick Grasso must return tens of millions of dollars in retirement pay should send shock waves through boardrooms.¹ Although the ruling could ultimately force Grasso to return upwards of \$100 million in compensation, the fight is far from over. Indeed, in many ways, it may have just begun.

This potentially long-lasting battle may turn out to be not solely about Grasso. Like the options backdating scandal, perhaps similar issues will envelop other executives and board members, and could conceivably spread like wildfire. What is “reasonable compensation” for deductibility purposes? What seems fair and reasonable from a fiduciary duty perspective? What standards govern the latter?

Tax deductibility surely isn’t the big issue here. For example, one can perhaps imagine a performance-based package that would not run afoul of tax deductibility standards, but that could nonetheless later prompt shareholder or board ire. At best, the questions those circumstances raise are amorphous, and they have ill-defined answers. However, their meaning today is becoming more focused. At least the stakes have never been as large as they are today.

In a whopping 73-page opinion, Justice Raymos of the New York State Supreme Court not only resoundingly criticized Grasso’s pay package, but also harshly rebuked NYSE board members for their failure to grasp what was going on and how much was being paid. Whether executive pay comes in the form of options or cash (or, as in Grasso’s case, in the form of a supplemental retirement benefit), there may be more of these skirmishes. And although it may be quite a while before any actual cash payback occurs (if it ever occurs in Grasso’s case), it’s worth visiting (or revisiting) a few tax effects that might ensue.²

Is the Repayment Voluntary?

It may sound silly now, but an initial question is whether a repayment is voluntary or compulsory. When

¹See Lucchetti and Lublin, “Grasso Is Ordered to Repay Millions in Compensation,” *The Wall Street Journal*, Oct. 20, 2006, p. A1.

²For full discussion, see Wood and Morris, “Boomerang Bonuses: Tax Effects When You Get It but Give It Back,” *Tax Notes*, May 2, 2005, p. 591, *Doc 2005-8676*, or *2005 TNT 79-27*.

I looked at this issue once before, it was based on a fact pattern involving Nortel executives who were being pressured to return bonuses.³ Unlike Grasso, the Nortel executives didn't vow to fight tooth and nail. They ultimately agreed — voluntarily — to repay \$8.6 million of cash bonuses.⁴ Perhaps talk of voluntary repayments has no bearing on Grasso's situation because so far it seems unlikely that any of this mess will end amicably.

Still, because cases do settle in all walks of life, the voluntary versus compulsory characterization distinction could conceivably arise. The question whether a payment is voluntary or compulsory comes up in other areas, for example, in the nondeductible fine or penalty context. There, the question is whether a payment made to a governmental agency is deductible as a settlement payment or is nondeductible as a fine or penalty under section 162(f). The taxpayer will argue that the payment was not compulsory and was not made with the expectation that some potential fine or penalty assessment will be dropped if the settlement payment is made.

In the "returning the bonus" context, few would presumably argue that any employee in his right mind would voluntarily (with no strings attached) give back compensation he has received. Still, the voluntary versus involuntary nature of the giveback may have a significant impact on the tax effects of what has to be an unhappy situation from the employee's perspective.

All of that makes me think that the question whether a repayment of compensation is voluntary or involuntary should not be a problem in most of these cases. Although some compensation disputes will settle, it seems unlikely that executives who "give back" compensation should have to run the voluntary versus involuntary gauntlet. As long as there has been ample evidence of legal claims for the return of the compensation (or even less formal criticism), and that activity leads to some kind of settlement agreement or other legal document spelling out the terms and conditions of the repayment, there should probably not be a problem with voluntariness.

Business Expense?

Whether voluntary or not, a logical first reaction is to suggest testing a payment against the standards for what constitutes a business expense. From an executive's perspective, claiming a business expense deduction might sound like a soothing balm to a fresh wound. For section 162 to apply, the repayment would have to be tested against the ordinary and necessary requirements, which may or may not be satisfied.

Despite the fact that a repayment of compensation has to be a highly unusual event, my guess is that the IRS or the courts would look at an executive under pressure as having good business reasons and business nexus for making a repayment, whether or not a lawsuit demanding repayment is filed. Still, there are some cases suggesting that a repayment may not generate a deduction if it is

less than compelled.⁵ But assuming that the payment is really mandatory (or is made in a settlement context and is close to mandatory), a section 162 deduction should be available.

Plainly, however, such a trade or business expense deduction will not put the taxpayer back in the position he would have been in before the payment. Not only will it almost invariably occur in a different tax year, but the 2 percent miscellaneous itemized deduction threshold and the alternative minimum tax will prevent the taxpayer from being made whole.

Whether the 2 percent threshold or the AMT will present a bigger problem will depend very much on the numbers. However, if one analogizes to the deductibility of attorney fees by an individual in a nonemployment-related suit, the AMT problem could be huge. Indeed, if the Grasso situation does become more commonplace, it probably will occur (as in Grasso's case) only on super-sized numbers. If a huge dollar figure must be paid back, the availability of a miscellaneous itemized deduction may be considerably less than half a loaf. It may be a mere slice or just crumbs.

Section 1341 Relief

Assuming the repayment is mandatory, it is worth reviewing section 1341 and the claim of right doctrine. That is far more attractive than section 162. Under section 1341, a taxpayer who previously reported income under a claim of right may be able to deduct the repayment in a later year (as long as the amount restored is greater than \$3,000). A section 1341 deduction usually provides a far better result than a deduction under any other code provision because it tends to place the taxpayer back in the position he would have been in had he never received the income.

Unfortunately, section 1341 is fraught with multiple tests.⁶ The basic section 1341 steeplechase includes the following:

- First, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to it. Surely, Grasso (or any other executive) seems likely to meet that test, having no knowledge or belief that he might have to return compensation when it is awarded.
- Second, a deduction must be allowed under another code section. Section 1341 is not a deduction-granting section, but rather operates like a piggy-back.⁷ Here, section 162, the ordinary and necessary business expense catchall, would, we hope, provide the enabling deduction that would be made bigger and better by section 1341.
- Third, the taxpayer must learn in a subsequent year that he did not have an unrestricted right to the item. The voluntary versus involuntary debate often

⁵See, e.g., discussion of *George Blanton v. Commissioner*, 46 T.C. 527 (1966), *aff'd per curiam*, 379 F.2d 558 (5th Cir. 1967); *Oswald v. Commissioner*, 49 T.C. 645 (1968); and *Pahl v. Commissioner*, 67 T.C. 286 (1976), all of which are discussed in Wood and Morris, *supra* note 2.

⁶See discussion in *id.*

⁷See *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969).

³See *id.*

⁴See Newman, "Giving Back the Bonus," *Business Week*, Jan. 24, 2005, p. 46.

hangs on that third point. Grasso probably should have no trouble with that one because if he does make a repayment, there should be ample evidence that he did not take it lying down. My guess is that in any circumstance in which compensation is paid back, someone will think about that issue, but hopefully the nature of the settlement documentation (for those disputes that do settle) should help eliminate the voluntary versus involuntary issue. Still, there are suggestions in the literature that one must have legal compulsion for the third hurdle of section 1341 to be circumnavigated. Be careful with that one.

Happily, however, even the IRS has occasionally applied section 1341 when a payment is made not based on legal compulsion but under threat of same. In Rev. Rul. 58-456,⁸ a corporation distributed excess mortgage payments to shareholders, violating its corporate charter. Under threat of legal action, the shareholders repaid the dividend and were able to restore their basis in their stock as if the distribution had never occurred.

Unfortunately, what authority there is under section 1341 does not seem to mesh well with the notion of repaying compensation. The court in *George Blanton v. Commissioner*⁹ faced an individual who repaid to his corporate employer a portion of his director's fees (which the IRS had ruled were excessive). The taxpayer did settle under a provision in his contract requiring him to repay any portion of the fees deemed excessive. In what I find to be a puzzling decision, the Tax Court denied a deduction under section 1341. The Fifth Circuit later affirmed the decision.

The Tax Court noted that it did not matter whether or not the repayment was compulsory. The court found that poor Mr. Blanton had no unrestricted right to the compensation in the first place — because the savings clause in the contract presumably did not operate to prevent that.

Later courts have softened that rigid stance,¹⁰ but it remains questionable how savings clauses in contracts or bylaws will be interpreted. The Sixth Circuit in *Van Cleave*¹¹ faced a repayment (aka savings) clause in the employment contract and in the bylaws. The 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. Indeed, the court found that section 1341 was designed for just that kind of situation, so the court awarded section 1341 benefits when the taxpayer had to give some of the money back.

Interestingly, though, the court in *Van Cleave* did not comment on whether the requirements to return salary imposed by the bylaws and by the employment contract were equally compelling, or if one of those alone would be sufficient. Thus, careful practice suggests providing

for repayment both in organizational documents (such as bylaws) and in employment and consulting contracts.

Of course, when such contracts or documents are created, few probably contemplate that those kinds of savings provisions will ever be called on to do their job. Even when they are explicitly considered, fewer still probably contemplate the executive's tax posture if and when the sad day of repayment eventually arrives.

Employment Taxes

Both the executive who is repaying compensation and the company that is receiving it will need to consider employment taxes. If the bonus is repaid within the normal statute of limitations, the company presumably could reduce its future employment tax withholding.¹² The company could then claim a credit on a subsequent employment tax filing for an overpayment of both its portion and the employee portion of the prior overpayment. As for the employee portion of that overpayment, the company could presumably either credit the repaying executive with that overpaid employee portion, or, if the executive has already paid it back, turn around and remit that overpayment back to the executive.

If the statute of limitations has expired, both the company and the executive may suffer, paying employment taxes on a compensatory payment that turns out (in the later year) not to be compensation at all.

Amending Tax Returns

Could Grasso amend his prior-year tax returns? Amending tax returns (within the statute of limitations) may have surface appeal because, after all, Grasso's compensation was ultimately judged to have been inappropriate. Arguably, therefore, it is as if the initial payment was not his to begin with.

Still, that possibility seems a real stretch. Amending prior-year returns is certainly allowed for mistakes, but was this a mistake? Our tax system generally does not allow a wait-and-see approach but is strictly annual. When Grasso received his pay, it was his. Later, at least according to the New York Supreme Court, things changed. That makes it unlikely that amending tax returns could work here.

Bylaw and Contract Provisions

Although it seems doubtful that too many executives and boards will be fretting over the possibility that a Grasso-like circumstance will be replicated in their own companies, I suspect there will be at least some reaction to that. It is not uncommon to find provisions in employment agreements and in corporate bylaws to the effect that any compensatory payment that is ruled to be excessive and unreasonable (for purposes of tax deductibility) must be repaid.

In light of the *Grasso* ruling, those provisions in contracts and governing documents may become more common. Moreover, the language of savings clauses may be expanded beyond the realm of mere deductibility concerns that we as tax lawyers consider. Increasingly,

⁸1958-2 C.B. 415.

⁹*Supra* note 5.

¹⁰*See, e.g., Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983).

¹¹*Id.*

¹²*See reg. section 31.6413(a)-1(b)(1).*

their focus may be the more amorphous fiduciary and liability standards currently being debated.

I'm not sure if those are two independent sets of standards or if they melt into one. Can one have a compensatory payment that is not deductible for federal income tax purposes but raises no ethical or securities law concerns? Conversely, can one have a tax-deductible compensation payment that, despite clearing that tax hurdle, runs afoul of other applicable standards?

As noted above, *Van Cleave* suggests that a repayment of compensation under one or more contractual or bylaw provisions will be OK. But the lack of specificity of that case, and its lack of seminal character, should make anyone paying back huge dollars that were taxed in a prior year somewhat uneasy.

Conclusion

Grasso's fight is far from over, and the implications of the judge's recent ruling (*before* trial, which in itself is pretty atypical) are only beginning to emerge. On top of

all the other implications of this mess, someone should be considering the tax implications to Grasso and to the NYSE.

Although give-backs may not become commonplace, there are already suggestions that Grasso's plight is not singular. Two top UnitedHealth executives recently agreed to forfeit approximately \$390 million in stock-option compensation (See Stecklow and Fuhrman, "UnitedHealth Executives Forfeit \$390 Million in Options," *The Wall Street Journal*, Nov. 9, 2006, p. B1.) The tax analysis to the company and to the executives that should go along with that mess may or may not involve some of the same considerations as Grasso's arguably more painful cash repayment.

If all the options are nonqualified options, for example, and all of them are unexercised, there may be no tax mess to undo. Still, someone should be looking at that one — and indeed at any give-back — quite carefully. Section 83 and other rules are always worth a revisit, and laying down any hard and fast rules about the tax effects of a give-back may be dangerous.

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