Tax Problems in Pay Clawbacks

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Why would an executive repay salary or a bonus? It could be a grand gesture or a publicity-geared gimmick. Public relations aside, it may be required.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) expands SEC regulatory authority, particularly in the area of the pay clawback liabilities directors and officers face after a financial restatement. Returning pay for services you've performed seems galling, and it turns out it creates a major tax problem.

Significantly, Dodd-Frank paybacks can be required even when directors and officers had no knowledge of wrongdoing. The clawback provisions in the Dodd-Frank law extend to all "executive officers," and apply to all incentive-based compensation received for three years following the filing of erroneous financials. The clawback appears to apply regardless of whether the executive officer had knowledge of, or participated in, the conduct that gave rise to the restatement of the company's financial statements.

Same Old Thing?

Clawbacks are not new. Section 304 of the Sarbanes-Oxley Act also has a limited clawback remedy. It applies only against the CEO and CFO of the company, and only for one year's worth of compensation received prior to a restatement. Perhaps more important, the Sarbanes-Oxley Act clawback provision requires bad intent.

The plaintiff's bar is already viewing the Dodd-Frank Act as a source of new business. The assumption is that it will be enforceable by class action or derivative suit. That will mean more pay givebacks. If you have to return pay, the tax questions bubble forth:

- Can you rescind the prior pay transaction?
- What happens if the giveback occurs in the next or following tax year?
- Can one be made whole by a tax deduction in a subsequent year?
- Who gets payroll taxes back, and how?
- If an executive returns a bonus, does he give back only his net check after payroll deductions?

Clearly, it will be easiest to address a pay giveback that occurs in the same year as the pay. W-2s will not have been issued so some undoing may be simple. Normally, however, the executive has previously included the payment in income, returns it in a subsequent year and wants to deduct it.

Hobson's Choice

There is a menu of tax choices, involving business expense deductions, amending a prior tax return, salary or bonus offsets, and deductions under Internal Revenue Code Section ("Code

Sec.") 1341. As we'll see, the latter seems best, but it is hardly free from complexity.

An executive required to give back pay surely can claim a deduction, but usually only as a miscellaneous itemized deduction. That means one must contend with the two-percent adjusted gross income floor, plus face phase-out and alternative minimum tax.

Amending a prior year tax return might seem cleanest. However, taxpayers can amend returns only within three years of filing the original return, or within two years of the date the tax was paid, whichever is later. The pay giveback might be later. Plus, amending a prior return is generally allowed only to correct a "mistake," and a pay giveback may not be a mistake for this purpose.

To effect a pay giveback, the company could agree to reduce the executive's current year salary. Of course, this would work only for *current* employees, and many repaying persons are *former* employees. Plus, it isn't clear if an offset would achieve the same public relations or legal effect.

Section 1341

Code Sec. 1341 embodies the "claim of right" doctrine. It attempts to place the taxpayer back in the position he would have been in had he never received the income. There is not much authority regarding the application of the claim of right doctrine to repayments of compensation. Perhaps compensation is not often repaid. Most of the authority that is present pertains to closely held corporations, and to repayments of nondeductible excessive compensation by controlling shareholders who are also officers, directors or employees.

The reason Code Sec. 1341 can be attractive relates to the alternatives. Other deductions can be subject to limitations, phase-outs and floors. Code Sec. 1341 is better. Yet it has conditions.

To claim a deduction under Code Sec. 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). This seems to fit clawbacks to a T. But Code Sec. 1341 is tricky, and far more nuanced than this thumbnail sketch suggests.

Generally, no deduction is allowed under Code Sec. 1341 where a taxpayer (after the IRS disallows the deduction) executes a contract requiring the return of the non-deductible portion of the compensation. Such a repayment is deemed to be voluntary. However, a deduction should be allowed if, prior to the IRS disallowing the corporate compensation deduction, the corporation's board enacts a resolution requiring repayment if the corporation cannot obtain a deduction and the taxpayer executes an agreement with his employer to do so.

Case Law Scarce

While there is not much case law to rely upon, a seminal Code Sec. 1341 case involves an officer who only owned approximately 25 percent of the corporation. In *G. Blanton*, 46 TC 527, Dec. 28,054 (1966), *aff'd per curium*, CA-5, 67-2 USTC ¶9561, 379 F2d 558 (1967), the taxpayer repaid his corporate employer the portion of his director's fees which the IRS determined to be excessive. He made the repayment pursuant to a contract (entered into after he received the fees, and possibly after the IRS deemed them to be excessive), which called for repayment of amounts the corporation could not deduct.

The court disallowed a deduction under Code Sec. 1341, since the circumstances, terms and conditions surrounding the original payment indicated the taxpayer lacked an unrestricted right to the amount. Later courts have softened the rigid stance that the repayment must come from the circumstances, terms and conditions surrounding the original payment. For example, in *E. Van Cleave*, CA-6, 83-2 USTC ¶9620, 718 F2d 193 (1983), the board adopted a resolution in 1969 that payments to officers later disallowed by the IRS must be reimbursed by the officer.

In addition to the bylaw change, the taxpayer entered into a separate contract with his controlled corporation that he would return his salary if the corporation could not deduct it. Van Cleave received compensation which the IRS later deemed to be excessive. Upon demand from the board, Van Cleave returned the excess.

On his tax return, Van Cleave deducted the repayment under Code Sec. 1341. The trial court characterized Van Cleave's return of his salary as "voluntary," since he controlled the corporation. The Sixth Circuit disagreed, allowing the deduction under Code Sec. 1341. The fact that a restriction on a taxpayer's right to income does not arise until a year subsequent to receipt does not affect the availability of Code Sec. 1341, the appellate court ruled. The court did not comment whether the bylaw requirement to return the salary and the similar contract provisions were equally compelling.

Dawn of Clawbacks?

We will see more clawbacks, and most will presumably be legally mandated. However, we may also see more "voluntary" pay givebacks in settlements and early stage investigations. The voluntary versus mandatory character of repayments complicates the tax analysis significantly. If one is being *urged* to give back pay but not *required* to, it isn't clear how these rules apply.