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Robert W. Wood

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Turning Down Pay Doesn’t Avoid Taxes

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Newspapers are full of stories about executives repaying their bonuses. Example: The CEO of Lloyds Banking Group waived a $3.7 million bonus. See Lloyds CEO To Waive 2011 Bonus. Execs may be motivated by altruism, pressure from shareholders or the public or even regulatory concerns. Sometimes it’s required by law.

But what’s the tax effect? Many sophisticated people assume the tax law follows the cash so there’s no income. How could there be when you receive it one day and hand it back the next? Even more clearly, if a bonus is announced but you turn it down ***before it’s paid***, surely it can’t be income, can it?

Welcome to the world of tax law where commonsense logic is turned on its head. Money payable that you turn down is constructively received by you. It prevents you from telling your boss not to pay your bonus in December but in January instead. Constructive receipt says it’s taxed in December even if your boss agrees.

Reason for Repayment. To navigate the tax maze, first ask whether the repayment is voluntary. A repayment motivated by altruism, shame, or patriotism may be more admirable but may yield a bleaker tax outlook. An executive who gives back a bonus when a law, court order, or administrative decree requires it runs an easier tax gantlet, although even that does not guarantee a rosy tax posture.

Consider—probably with a tax professional—these tough questions:

- Does the giveback occur in the same year as the pay? Sometimes the tax code allows you to undo a prior transaction.
- If you return compensation in a later year, can you be made whole by a tax deduction?
- If you return a bonus, do you give back only your net check ***after*** payroll deductions? Who gets the payroll taxes?

Amending Prior Year Returns. Amending a prior return is generally allowed only to correct a mistake, and a pay giveback may not be a "mistake."

Business Expense? Someone ***required*** to return pay can claim a business expense deduction, but usually only as a miscellaneous itemized deduction (subject to the 2% floor plus AMT).

Salary Reduction? To effect a pay giveback, the company could agree to reduce the executive's *current* salary.

Section 1341. Section 1341 is a highly complex provision. To claim a deduction, you must have included the income in the prior year because you had an unrestricted right to it then. You learn in a later year you did not so you have to give it back. But Section 1341 is tricky, far more nuanced than this thumbnail sketch suggests.

Beware. If you are being urged to give back pay but are not required to get some professional advice. The voluntary versus mandatory character of the repayments complicates the tax analysis significantly. The tax headaches can be lasting so be careful.

For more information on pay giveback tax effects, see:

Deducting Pay Give-Backs

Execs Who Forfeit Pay

Deducting McGuire's $620 Million Forfeiture

Giving Back Bonuses: Easy; Getting Tax Deductions: Priceless

Big Board Payback

Better to Give Than Receive? Tax Effects of Returning Compensation

Boomerang Bonuses: Tax Effects When You Get It But Give It Back

Giving Back The Bonus

Will Everyone Pay AMT Next Year?

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.