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Robert W. Wood
THE TAX LAWYER

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Wells Fargo Exec Pay Clawbacks Could Hurt Like Fake Accounts

Wells Fargo executives probably can't command too much sympathy these days. Outrage continues over the Wells Fargo fake account scandal, and executives aren't out of the woods yet. In fact, Congress is getting involved. Now, Senators are pushing Wells Fargo for pay clawbacks. Wells Fargo has already agreed to pony up $190 million in penalties and customer payouts over its appalling creation of accounts without customers' knowledge.

The government apparently gets to keep most of this $190 million, with only approximately $5 million going to customers. But pay clawbacks–if they happen–would be a personal rebuke to executives. Some lawmakers want to use the fraud settlement to segue into clawbacks of compensation paid to Wells Fargo executives. One theory of clawbacks is that even if management did not *actually* know about the widespread account creation issue, they *should* have known.

(Photo by Joe Raedle/Getty Images)

Wells Fargo's board may have to consider whether to cancel or claw back any incentive compensation. One target could be Carrie Tolstedt, who is now-retired. As for Well Fargo's CEO John Stumpf, Democratic Senators Jeff Merkley of Oregon and Elizabeth Warren of Massachusetts called for his resignation. Sen. Warren said that Mr. Stumpf should give back his salary and be criminally investigated.

Returning pay for services you've performed can create *major* tax problems. The Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203) expanded SEC regulatory authority, particularly in the area of clawback liabilities that directors and officers face after a financial restatement. Paybacks can be required even when directors and officers had no knowledge of wrongdoing.

Clawbacks are not new. Section 304 of the Sarbanes-Oxley Act also has a clawback remedy. Yet it applies only to the CEO and CFO, and only for one year's compensation prior to a restatement. Sarbanes-Oxley's clawback provision also requires bad intent. If you have to give back pay, how does it affect taxes? Does the tax code allow you to undo a prior transaction? Every tax year stands on its own and requires an annual tax return, but the giveback usually happens in a later tax year. Can you be made whole by a tax deduction in a subsequent year?

Often, the answer is no. Besides, how can you get payroll taxes back? If an executive returns a bonus, does he give back only his net check after payroll deductions? Normally, the executive has previously included the payment in income and returns it in a subsequent year. The tax filing choices include business expense deductions, amending the prior year tax return, salary or bonus offsets, or deductions under tax code Section 1341. The latter is usually best, but it is complex.

An executive required to give back pay surely can claim a business expense deduction, right? 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. Amending a prior year tax return might seem considerably easier. 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. A pay giveback may not be a 'mistake.' To effect a pay giveback, the company could agree to reduce the executive's current year salary. Of course, this works 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 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. Other deductions can be subject to limitations, phase outs and floors. 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).

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.

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