PERSPECTIVE

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What If You Must Return Pay, Like Wells Fargo?

By Robert W. Wood

In the wake of its fake account scandal, Wells Fargo installed a new chief executive, reformed its sales incentives, and clawed back more than $60 million in stock awards from executives. Recently, an internal investigation revealed that the improper sales practices go all the way back to 2002. That prompted Wells Fargo to claw back another $75 million, and to retroactively fire Carrie Tolstedt, the former head of the unit in charge of the unauthorized sales.

Depending on how you count, Wells says this is the biggest payback in corporate history. In all, Wells tallies the amount to something like $180 million. And there were big fines and other settlement payments too. Wells has good reason to pay attention.

A 113-page report makes the scandal look even worse. *See* Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report (April 10, 2017). Any claw back of pay can be dramatic, but these are huge and far-reaching, sending a big message that Wells Fargo is contrite and taking action.

Yet, during tax filing season particularly, it is appropriate to wonder about the difficult tax issues any unwinding can present. The first Wells Fargo pay clawbacks last year were of unvested stock options recouped from former CEO John Stumpf ($41 million) and Tolstedt ($19 million). Taking back unvested stock options is fairly simple.

The fact that they were unvested means they were not really pay yet, at least not in the traditional sense. Tax wise, that makes them vastly easier to undo than if Wells Fargo had issued a payroll check and had to get it back after it was cashed and income and payroll taxes were paid.

Say you get a payroll check for $100,000, of which your take home pay after taxes is $60,000. Then, you are ordered to return it. Do you owe $100,000, $60,000 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 giveback are big factors.

Let's start with the reasons clawbacks happen. The Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the regulatory authority of the Securities and Exchange Commission. Under this law, 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.

On top of these rules, some clawbacks are the result of lawsuits, or from board actions that attempt to address public relations disasters. But how all this plays out with the IRS and state taxing authorities can be quite different. In general, the IRS doesn't allow you to undo a prior transaction as if it never occurred.

A true rescission is sometimes possible, but only if everything occurs (including the original pay and the giveback) in the same tax year. In most cases involving regulatory, lawsuit or board action, the giveback happens in a later tax year. We all have to pay taxes annually. And often you can't just amend your prior year tax return either.

Amending a prior tax return is generally allowed only to correct a mistake you made at the time you filed the original. A pay giveback is really not a 'mistake,' since you were entitled to the pay when you received it. Besides, there's also the timing problem.

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. But, you can surely claim a business expense deduction for giving back pay that you reported as income, right? Maybe, yes. But how much good that deduction will do you can be a shocker.

Usually, it would only be a miscellaneous itemized deduction, subject to the 2 percent adjusted gross income floor. Plus, depending on your income, you may well face the phase out of your itemized deductions as well as the alternative minimum tax. Both of those can mean extra taxes.

The payroll tax problem of income and employment taxes is also quite thorny. If you are lucky, your company could agree to reduce your *current* year salary. Yet, this works only for *current* employees that make enough money to cover the clawback.

And as is occurring with Wells Fargo, many repaying persons are *former* employees. So, the likelihood that a payback can be handled with go-forward a salary reduction is small. Besides, one wonders if a pay offset would achieve the same kind of public relations impact as a real payback that looks and sounds like a disgorgement.

For all of these reasons, most people in the unenviable position of giving back end up claiming an odd kind of tax refund under Section 1341 of the tax code. California tax law has a provision parallel to Section 1341. 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.

Of course, it's complex. 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.

In fact, there are frequent problems in application, and in the IRS reaction to it when it sees this item on a tax return. There's also the question of voluntary vs. mandatory givebacks. 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 significant.

Even so, when a highly-paid executive has to return some pay, many people may not have much sympathy. Perhaps it is similar to someone ordered to pay restitution. Deducting restitution can also be hard. And no one likes to be taxed on money they don't get to keep!

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