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Dewey LeBoeuf Clawback Deal Showcases Disgorgement Pains

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The latest deal for former Dewey LeBoeuf partners calls on them to cough up $90M. See For Dewey: A $90 Million Bill. That's down from $103.6M but still represents a huge payback for some of the failed firm's former partners. The range of contributions was widened too. Previously, it was $25,000 to $3M per partner. Now it's $5,000 to $3.5M. See Dewey Seeks 'Clawbacks'.

The proposed deal could impact 672 former partners who have until August 7, 2012 to decide. Some creditors like it but others think it's too little. If the plan goes forward and the partners kick in, how they will be taxed looms as a big problem.

The same problem arises in virtually any pay giveback, and they are becoming more and more common. Every tax year stands on its own, and the tax code allows rescission–simply undoing the original pay–only if done in the ***same year***. See Sell Then Rescind? IRS Respects Some Do-Overs.

Can't they claim a tax deduction? Sure, but when you give back pay it may not make them whole. For one thing, if payroll taxes have been paid, getting them back involves the IRS. A list of possibilities includes:

Claiming a Business Expense? They might claim business expense deductions for giving back pay, but it may be a miscellaneous itemized deduction subject to the 2% adjusted gross income floor. That means alternative minimum tax (AMT). See Will Everyone Pay AMT Next Year?

Amending Prior Tax Returns? Amending a prior return is only possible within three years of filing the original return or within two years of the date the tax was paid, whichever is later. See Even The IRS Has Time Limits. Besides, amending a prior return is generally allowed only to correct a mistake. A pay giveback may not qualify. See 5 Simple Rules to Follow When Amending Your Tax Return.

Reduce Current Salary? Agreeing to reduce ***current*** salary obviously won't work if the company is gone.

Section 1341? This possibility is best but hardest to explain. Section 1341 attempts to put you back where you would have been had you never received income. You must have reported income in a prior year when you had an unrestricted right to it ***then***. You must learn in a ***later*** year you did ***not*** have an unrestricted right after all (*i.e.*, you have to give it back).

This fits seems to fit pay clawbacks to a T. The problem is that Section 1341 is tricky and far more nuanced than this thumbnail sketch suggests. It's a kind of "don't try this at home" tax provision so be careful with this one.

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