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Pay Clawbacks Bring Tax Problems

"Giving back" may sound philanthropic, but repaying salary or a bonus when you are *required* to is anything but. Returning pay for services you've performed seems galling. Plus, it turns out pay givebacks create *major* tax problems. And you thought only your bank account would be depleted!

The Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203) expands SEC regulatory authority, particularly in the area of the clawback liabilities directors and officers face after a financial restatement. Significantly, paybacks can be required even when directors and officers had no knowledge of any wrongdoing. That means more highly paid people will be forced to give money back, and the tax glitch this creates is surprising.

The clawback provisions in the Dodd-Frank law extend to all "executive officers." They 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.

Clawbacks are not new. Section 304 of the Sarbanes-Oxley Act also has a clawback remedy, but one that is quite limited. 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. There are other clawback circumstances, too.

For example, California Attorney General Jerry Brown has filed a civil lawsuit to recover big bucks from Bell city officials who were earning six figure salaries in the otherwise not illustrious blue collar Los Angeles suburb. Brown alleged fraud and announced he is broadening his investigation of Bell and nearby cities into a statewide probe. Brown is targeting local and other government agencies paying annual salaries of more than $300,000 and pensions greater than $200,000. See California Attorney General Sues Officials Over Salaries.

Pay It Back! If you have to give back pay, you may deplete your bank account, but how does it affect taxes? In particular:

- Does the tax code allow you to undo a prior transaction?
- Every tax year stands on its own and requires an annual tax return, so what happens if the giveback happens in a later tax year?
- If you give back compensation, can you be made whole by a tax deduction in a subsequent year?
- If a deduction is warranted, when do you get it?
- Who gets payroll taxes back and how?
- If an executive returns a bonus, does he give back only his net check after payroll deductions?

It will be easiest to address a giveback occurring in the same year as the pay, but this seems rare. Normally, the executive has previously included the payment in income and returns it in a subsequent year. There is a menu of tax choices, but nothing that seems as obvious or easy.

The tax choices may involve business expense deductions, amending the prior year tax return, salary or bonus offsets, or deductions under tax code Section 1341. As we'll see, the latter seems best, but it is hardly free from complexity.

Business Expense? 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, he faces phase out and alternative minimum tax.

Amending Prior Year Returns. 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. (See Even The IRS Has Time Limits.) 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.

Salary Reduction? 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. 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). This seems to fit clawbacks to a T. But Section 1341 is tricky, and far more nuanced than this thumbnail sketch suggests.

Dawn of Clawbacks? We will see more clawbacks, and even more "voluntary" pay givebacks in settlements and early stage investigations. If the voluntary versus mandatory character of the repayments is an issue, it complicates the tax analysis significantly. 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 will be palpable. Get some professional help and be careful.

For more information on pay giveback tax effects, see:

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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

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