Compensation Clawbacks: Tax Consequences For Issuers And Executives

Mastering Clawbacks & Corporate Compensation
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What is a Clawback?

- Traditionally: Recoupment of compensation after it is earned for violation of company policy, agreement or law

- Sources of traditional clawbacks
  - Company policy or agreement (e.g., violation of non-compete)
  - Federal agency enforcement policy
  - Shareholder suits

- No-fault clawbacks under recent federal statutes
  - Sarbanes-Oxley Act of 2002 § 304
  - Emergency Economic Stabilization Act of 2008 § 111 (TARP Clawbacks)
  - Dodd-Frank Wall Street Reform and Consumer Protection Act § 954
    - Recovery of “erroneously awarded incentive-based compensation” if issuer is required to restate earnings due to “material noncompliance” with disclosure obligations of federal securities law. SEC Proposed Rule 10D-1.
I. Company’s Deduction
Deducting Bonuses: The General Rule

■ Code Section 404(a)(5): Deferred compensation deductible in company’s fiscal year in or with which ends employee’s taxable year in which employee takes amount into income, rather than when accrued. Generally:
  - Compensation received more than 2 ½ months after company’s taxable year of related services: deductible in year employee takes amount into income
  - Compensation received within 2 ½ months after taxable year of related services: deductible in company’s taxable year of accrual.

■ Employee “receives” compensation for income tax purposes when paid or made available without substantial limitations or restrictions

■ Compare with proposed Rule 10D-1: Employee “receives” incentive-based compensation in employer’s fiscal year in which financial reporting measure specified in compensation award is attained.

■ For accrual basis taxpayer, deduction accrues when all events have occurred to fix fact and amount of liability.
Impact of Clawback Policy on Company Deduction

- Compensation subject to clawback is accrued under normal principles; clawback contingency is “remote” and should not defeat accrual. See United States v. General Dynamics Corp., 481 U.S. 239 (1987)

- But if incentive based compensation is deducted in one taxable year of company, and recouped in subsequent taxable under Rule 10D-1 as erroneously awarded incentive-based compensation, company might have to take amount back into income in year of recoupment, under the “tax benefit rule,” which generally requires income inclusion of amount previously deducted when events occur that are “fundamentally inconsistent” with the earlier deduction. See, e.g., Larchfield Corp. v. United States, 373 F.2d 159 (2d Cir.1966), Code section 111(a).
Example

- Company with fiscal year ended 12/31:
  - December 2013: grants RSU to Executive Officer, to be settled only if target financial reporting measure attained by end of three-year period ending 12/31/2016
  - December 31, 2016: specified financial reporting measures met
  - March 1, 2017: Company pays cash under RSU to Executive Officer, and accrues deduction for taxable year ended December 31, 2016
  - In 2017, board concludes 2016 financial statements contain a material error rendering entire RSU settlement “erroneously awarded incentive-based compensation”
  - In 2018, company files Form 8-K reporting restated financials
  - In 2018, Executive Officer repays RSU settlement amount to company

- Tax consequences to company
  - RSU is incentive based compensation “received” for Rule 10D-1 three-year lookback rule in company’s 2016 fiscal year
  - RSU “received” by Executive Officer for tax purposes on March 1, 2017: Company accrues and deducts for its 2016 taxable year, reports on Executive Officer’s 2017 W-2
  - Company takes 2016 RSU deduction into income in 2017 or 2018, depending on when it decides the “fundamentally inconsistent” event occurs
II. Withholding, Reporting and Tax Impact on Employee
Repaying Compensation in the Same Year - Easy

- Bonus repaid in same year paid – for income and FICA tax purposes, treated as if never paid

- EXAMPLE
  - Executive Officer is paid $100K incentive-based bonus on March 30, 2018, based on 2017 financial reporting measures
  - Bonus is “received” for tax purposes in employee’s 2018 taxable year, even though “received” for Rule 10D-1 purposes in company’s 2017 fiscal year
  - Executive Officer repays $100K to company on December 1, 2018
  - Company does not report $100K on Executive Officer’s 2018 W-2. Company can generally reverse any resulting over-withholding (for example, if employee repays by writing a check) by reducing withholding taxes from remaining compensation payable in 2018.
Repaying Compensation in Later Year – Hard

EXAMPLE

- Executive Officer receives $100K bonus in 2017, pays tax on 2017 Form 1040
- Executive Officer repays $100K bonus in 2018 under Rule 10D-1.
- 2018 reporting and withholding: IRS says Company may not report or withhold on employee’s 2018 wages net of the 2018 $100K bonus repayment
- This is so even if company enforces recovery by withholding $100K from compensation otherwise payable in 2018 pursuant to Board discretion regarding “manner of recovery.” Rev. Rul. 79-311, 1979-2 C.B. 25
- Executive Officer cannot amend his/her 2017 tax return
  - “Claim of right” doctrine – based on principle of annual income tax accounting
- Executive Officer can deduct $100K on 2018 tax return under Code section 165 as miscellaneous itemized deduction
- But miscellaneous itemized deduction is limited by 2% floor and is not available against alternative minimum tax (AMT)

Executive Officer must claim section 1341 relief to avoid 2% floor and AMT
Repaying Compensation in Later Year: Can We Argue This Too Is Easy?

- Recap of last slide: Under Rev. Rul. 79-311, 1979-2 C.B. 25: If employee is paid $100K in Year 1 and repays in Year 2, must withhold on and report Year 2 compensation without netting out $100 repayment – even if repayment enforced by offset against Year 2 compensation. Employee can recover taxes paid on $100K in Year 1 only to extent employee can claim deduction in Year 2 plus make-whole Section 1341 relief.

- Tax issue will arise, for example, for Rule 10D-1 clawbacks if SEC allows board discretion to arrange for repayment via offset from other compensation. See 80 Fed. Reg. 41144, 41163 (July 14, 2015).

- Can company take position that Revenue Ruling 79-311 is wrong – repayment of $100K in Year 2 may be netted from Year 2 compensation for all reporting and withholding purposes.
  - But company bears risk of under-withholding and penalties
Code Section 1341 Eliminates 2% Floor and AMT

- Section 1341 allows “make-whole” treatment of repaid amount

- Taxpayer gets “better of” deduction or refundable credit:
  - Deduction for year of repayment (without 2% floor or AMT) or
  - Refundable credit equal to additional tax in year of payment
  - Both deduction and credit approach eliminate 2% floor and AMT

- Statute
  - Repayment over $3,000
  - Deductible under another Code section
  - *It appeared* that taxpayer had *unrestricted right* to payment in year of payment
  - Established after close of year that *taxpayer did not have right to payment*
Code Section 1341 –
IRS Rulings Not Clear or Consistent

- IRS Position: Section 1341 available for repayment of amounts to which taxpayer had an “apparent but not actual right,” based on all facts available to taxpayer in taxable year of payment, but subsequently determined to be mistaken.
- “Apparent but not actual right” test very difficult to apply. For example, if Executive Officer receives performance based compensation in Year 1, and repays it in Year 2 because it is determined to have been “erroneously awarded” under Rule 10D-1, can he/she claim section 1341 relief?
  - Arguably NO, because taxpayer had not even an “apparent right” to bonus under the correct financial reporting facts “available” to her in year of payment. See Rev. Rul. 68-153 situation 2.
  - Arguably YES because taxpayer had an “apparent right” under original financial reporting, subsequently determined to be mistaken. See Rev. Rul. 68-153, situation 3
  - Arguably NO because under the company’s original financial reporting, taxpayer had an “actual” right to the bonus, defeated by a subsequent event, namely, the restatement, See Rev. Rul. 68-153, situation 4 – especially if SEC gives board discretion on whether and how to enforce clawback. See, e.g., 80 FR 41144, 11163 (July 14, 2015).
- IRS rulings not always consistent and do not always follow “apparent but not actual right” test.
Code Section 1341 – Courts Don’t Like IRS “Apparent But Not Actual Right” Test

- In *Dominion Resources*, 4th Circuit rejected IRS apparent-but-not-actual right test, applied “same circumstances” test. Tax Court, Court of Federal Claims, and the five Federal Courts of Appeal to have review issue adopted this test. None has adopted IRS position.
  - Section 1341 applies if original repayment payment made because of specified “circumstances, terms and conditions,” and repayment made because those “circumstances, terms and conditions” were not satisfied
  - Under the “same circumstance test,” section 1341 should be available for repayment of bonus, when bonus is incentive-based compensation and subsequently repaid because determined to be erroneously paid compensation on basis of restated financials

- Some IRS rulings follow the “same circumstances” test: Revenue Ruling 72-78, 1972-1 CB 45; Revenue Ruling 2004-17, 2004-1 CB 51
Section 1341 - And Now The Nacchio Test…

- *Nacchio v. US*, United States Court of Federal Claims, March 12, 2014
- Former CEO convicted of insider trading; disgorged $45 million profits
- In refund claim, sought $18 million credit under section 1341 for income taxes paid on profits received but subsequently forfeited
- Government sought summary judgment that section 1341 not available:
  - Repayment not deductible in first instance, under section 162(f) (no deduction for “fines or similar penalties”)
  - Taxpayer had no “apparent right” to gains based on illegal trades
- Claims Court denied summary judgment:
  - Dismissed 162(f) argument
  - Whether taxpayer had apparent right under section 1341 depends on whether he “subjectively believed” he had right to funds. This is a question of fact
  - Criminal conviction via jury verdict not relevant to his subjective belief; taxpayer did not plead guilty
Some Code Section 409A Issues

- In requiring repayments of nonqualified deferred compensation subject to Code Section 409A, keep in mind the basic Section 409A rules:
  - No accelerations (Code Sec. 409A(a)(3))
  - No subsequent deferral elections (outside of 12-month/5-year rule, Treas. Reg. Sec. 1.409A-2)
  - No substitutions (Treas. Reg. Sec. 1.409A-3(f))

- Repayment of compensation not yet paid and taken into income
  - Simplest solution: Clawback policy provides for forfeiture
  - Section 409A permits forfeiture if not accompanied by substitution of other amount payable at another time (Treas. Reg. Sec. 1.409A-3(f))
  - For Rule 10D-1 clawbacks, permissibility of repayment via forfeiture will depend on final SEC rule. See generally 80 Fed. Reg. 4114, 41163-4 (July 14, 2015)

- Repayment of compensation already paid and taken into income
  - Under Section 409A, issuer should be able to offset against compensation payable in later year, unless it reports and withholds on net basis in contravention of IRS position under Rev. Rul. 79-311. Netting could arguably raise Section 409A issues under no-substitution rule.
Recovering FICA taxes

- Claim of right doctrine does not apply to FICA taxes
- Use procedures under Code section 6413 for erroneous overpayments
- Employer recoups FICA taxes withheld by filing Form 941-X within statute of limitations (3 years after filing original Form 941)
- Employer must repay employee’s share of withheld FICA taxes to employee, by reducing FICA taxes withheld from other wages, or directly
- Also Employee must repay compensation to Employer
  - Does employee have to repay gross payment, or payment net of FICA taxes already withheld?
  - Answer not entirely clear but recent IRS guidance suggests repayment of net amount is sufficient (but note that proposed Rule 10D-1 requires that Executive Officer repay entire pre-tax amount of erroneously awarded incentive-based compensation)
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