

# Taxation of Executive Compensation Clawbacks

ABA Section of Taxation  
2011 May Meeting  
Employee Benefits Committee  
Subcommittee on Executive Compensation  
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## What's a Clawback?

- Recoupment of compensation, traditionally upon violation of law, contract or company policy
- Sarbanes-Oxley Clawbacks
  - CEO or CFO returns incentive-based compensation upon financial restatement caused by misconduct of the issuer
  - No personal fault by CEO or CFO required
- Dodd-Frank Clawbacks
  - Material financial restatement of issuer
  - Recover from every current and former "executive officer" incentive compensation paid in three years preceding restatement
  - Repayment measured as compensation not payable absent misstatement
  - "No-fault" basis

## What Do I Have to Think About?

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- Basics
- Retroactive clawbacks
- “Bad boy” clawbacks
- 409A issues
- Other former employee issues
- Employer stock
- FICA

## Repaying Compensation in the Same Year - Easy

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- Repayment in same year as payment – treated as if never paid
- Example
  - 2010 compensation = \$100 bonus + \$10 bonus
  - \$10 bonus repaid in 2010
  - Employer reports \$90 as wages and income on W-2
- Same tax treatment applies whether \$10 repayment held back from compensation otherwise payable or paid directly by check
- Authorities: *Couch v. Commissioner*, 1 BTA 103 (1924), *acq.* IV-1 C.B. 1 (1925); *Russel v. Commissioner*, 35 BTA602 (1937), *acq.* 1937-1 C.B. 22, and progeny; Revenue Ruling 79-311, 1979-2 C.B. 25

## Repaying Compensation in Later Year – Hard Revenue Ruling 79-311 Approach

- Example
  - Employee receives \$10 bonus in 2010
  - Employee repays \$10 bonus in 2012, when compensation = \$100
- 2010 tax return
  - \$10 remains in 2010 gross income under “claim of right” doctrine
- 2012 tax return under Revenue Ruling 79-311
  - \$10 paid directly or held back from \$100 compensation otherwise payable
  - Net wages = \$90
  - W-2 income and wages = \$100
  - Employee may deduct \$10 under section 162 or 165(c)(1) in connection with employee’s “trade or business” of being an employee
- But 2012 deduction is limited by
  - 2% floor
  - Alternative minimum tax (AMT)

## Section 1341 Eliminates 2% Floor and AMT

- Section 1341 allows “make-whole” treatment of paid back amount
- Taxpayer gets “better of”
  - Deduction for year of repayment (without 2% floor or AMT) or
  - Credit equal to additional tax in year of payment
- 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 the close of the year that taxpayer did not have right to payment

## Section 1341 – IRS View

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- “ Apparent right” test
  - Section 1341 applies if at time of payment, taxpayer had “apparent” but not “actual” right to payment
  - Example: section 1341 should apply to Dodd-Frank clawbacks of bonuses first paid after clawback policy in place (taxpayer’s right only “apparent”)
  
- Problems with “apparent right” test
  - “Retroactive” clawbacks applied to bonuses paid before clawback policy in place – employee had both apparent and actual right. Does 1341 apply?
  - Clawbacks triggered by breach of non-compete agreement
  - Difficulty in distinguishing between “actual” and “apparent” right

## Section 1341 – Case Law

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- Same circumstances test
  - Section 1341 applies if original payment made because of specified “circumstances, terms and conditions,” and repayment made because those “circumstances, terms and conditions” were not satisfied.
  - *Dominion Resources v. U.S.*, 219 F.3d 359 (4<sup>th</sup> Cir. 2000)
  
- Same circumstances test allows section 1341 for clawbacks where IRS apparent right test might be problematic
  - Retroactive clawbacks
  - Clawbacks triggered by breach of non-compete agreement

## Possible Alternative to Revenue Ruling 79-311 – Net Repayment From W-2 Wages and Income

- Example:
  - Employee receives \$10 bonus in 2010
  - Employee repays \$10 bonus in 2012 by having \$10 held back from \$100 compensation otherwise payable in 2012
  - Employer reports net \$90 on employee's W-2
  
- Is netting approach permitted? Authorities are mixed
  - Pro: Revenue Ruling 2002-84, Revenue Ruling 80-9; Revenue Ruling 67-530; *Drummond v. Commissioner*, 43 BTA 529 (1941); *Moorman v. Commissioner*, 26 T.C. 666 (1966), *acq.*, 1956-2 C.B. 7
  - Anti: PLR 9103031
  
- And theories are mixed
  - Pro: compensation is payable for multi-year services, and can be reduced in one year to reflect under-performance in earlier year. See "reasonable compensation" cases.
  - Anti: set-off taxable under assignment of income or constructive receipt doctrines

## Retroactive Clawbacks – Special Issues

- Some employers apply clawback policy to payments first made before policy put in place
  
- Deductible (under section 162 or section 165(c)(1))?
  - Under "unreasonable compensation" cases – possibly no
  - Better answer: these cases are distinguishable
  
- Section 1341 available?
  - Under IRS facts-in-existence test, unclear
  - Under *Dominion Resources* theory, probably yes

## Bad Boy Clawbacks – Special Issues

- Section 1341 available?
  - IRS “apparent right” test – unclear
  - *Dominion Resources* same-circumstances test – probably yes
- “Claim of Wrong” doctrine
  - Applied only rarely, in egregious circumstances

## 409A Issues

- Section 409A – prohibited-substitution rule
  - Treasury Regulation Section 1.409A-3(j)(4)(xiii) puts \$5,000 cap on permitted acceleration of “payment” in satisfaction of debt of the service provider
- Example:
  - Employee receives \$100,000 bonus in 2010, which is clawed back in 2012
  - Employee is owed \$500,000 parachute (nonqualified deferred comp) in 2012
  - Employee is paid parachute of \$400,000 (= \$500,000 - \$100,000 bonus clawback)
  - \$500,000 reported as wages and income on W-2 in compliance with Revenue Ruling 79-311
- OK under Section 409A prohibited-substitution rule?
  - Yes. Entire \$500,000 parachute included in income and wages – “payment” occurs as scheduled, in compliance with Section 409A



## FICA

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- Claim of right doctrine does not apply
- Employer and employee can recoup FICA taxes withheld and paid (within three year statute of limitations)
- Use procedures under Code section 6413 for erroneous overpayments
- Use Form 941-x