Taxing Clawbacks: Theory and Practice

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This report explores the tax treatment of compensation clawbacks and addresses the tax treatment of clawbacks generally and the tax questions raised by the many special cases likely to arise. These include compensation setoffs, or holdbacks, and their issues under sections 61 and 409A; the tax treatment of repaying employer stock under section 83; the special issues under section 162 or 165 and section 1341 raised by retroactive clawbacks imposed on amounts paid before the clawback policy was in place; ''bad boy'' clawbacks and clawbacks from former employees; section 409A problems; and FICA tax questions.

This report is intended to be both theoretical and practical. Many tax issues raised by repaying compensation are surprisingly complex and indeterminate. Some seemingly simple questions have no clear answers either in guidance or in income receipt theory. While exploring these knottier conceptual issues in detail, this report attempts to resolve them by setting forth reasonable tax positions. The report summarizes these practical conclusions in its introduction and again in its final section.

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Compensation clawbacks — recoupment of executive pay to penalize violations of company rules or policy — are the flashiest new gadget in the corporate governance toolbox. Clawback policies may be adopted for many purposes, for example, to punish activity detrimental to the company, to enforce a former employee's covenant not to compete, or to recoup performance bonuses on an earnings restatement affecting the year for which the bonus was paid.

The Dodd-Frank Wall Street Reform and Consumer Protection Act gives clawbacks dramatic new salience. As a condition for being listed on a U.S. stock exchange, every publicly traded company must develop a clawback policy.[1] Upon a material financial restatement, the company must recover from every current and former executive officer any incentive-based compensation paid in the three-year period preceding the restatement, to the extent the compensation was based on the erroneous data. The clawback is measured as the excess of the amount paid over the amount that would have been paid absent the erroneous financial information. The clawback applies regardless of personal wrongdoing. The statutory provision has no effective date, but regulators are widely assumed to be readying the requirement for the 2011 proxy season. One of many unknowns is whether Dodd-Frank clawbacks will be retroactive — that is, whether they will affect incentive pay awarded before the clawback policy is adopted.

Among the many knotty legal issues raised by clawbacks is their appropriate tax treatment.[2] If the employee repays amounts that were subject to

[1]Section 10-D of the Securities Exchange Act of 1934 is added by section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203).

[2]Two articles first to spot and address the tax issues raised by clawbacks are Robert W. Wood and Richard C. Morris, ''Better to Give Than to Receive? Tax Effects of Returning Compensation,'' *Taxes*, Nov. 2005, at 25; and Robert W. Wood, ''Giving Back

(Footnote continued on next page.)

income and FICA taxes when originally paid, can the employee reverse taxes previously paid on the relinquished amount? By a deduction under section 162 or 165(c)(1)? By the claim of right deduction under section 1341? Is the answer different for repayments paid directly by check than for those held back from other pay? For current employees rather than for retirees? For repayment of payments first made before the clawback policy was adopted, rather than for those payments made after? For repayments of employer stock that has fallen in value since first included in income? Finally, section 409A throws an unexpected monkey wrench into clawbacks enforced by holdback from nonqualified deferred compensation. How can these clawbacks be enforced without triggering tax and penalties under section 409A?

This report addresses and resolves these and other tax questions arising from clawbacks. It is organized as follows:

General tax treatment of clawbacks. Part I sets forth the tax treatment of clawbacks generally. If repayment occurs in the same year as the original payment, the original payment is treated for tax purposes as never paid. The repayment is excluded from the wages and gross income reported on Form W-2. This wage and income exclusion applies whether repayment is held back from other compensation or paid directly by a check written from the employee to the employer.

If the employee repays compensation first paid in a prior year, he may not amend that prior year's return to exclude the payment from that prior year's gross income. Further, the employee's repayment may not be excluded from (netted against) the employee's gross income in the repayment year. Rather, the IRS takes the position that the employer must include the repayment in the gross income and wages reported on the employee's Form W-2. The employee may partially reverse the taxes already paid on the relinquished amount by claiming the repayment as an itemized deduction, subject to the 2 percent floor for miscellaneous itemized deductions and the alternative minimum tax. In most cases, the employee may eliminate the burdens of the 2 percent floor and the AMT by also claiming section 1341 treatment for the repayment.

If a prior year's payment is repaid by being held back from other compensation rather than directly by the employee's check to the employer, the required income reporting treatment is apparently, but not certainly, the same. To be consistent with direct repayments, those holdbacks would be included in the employee's Form W-2 wages and gross income, even though they were not actually received by the employee. The employee would claim a deduction for the held-back amounts under section 165 or 162, and section 1341 if available. Surprisingly, however, it is not entirely clear that gross income inclusion is required for holdbacks. The authorities — including the IRS's own rulings — are mixed, and the rationale for the income inclusion position is weak. For the employer preferring to avoid risk of under-withholding penalties, inclusion of any holdbacks in the employee's Form W-2 gross income and wages is preferred, and doing so ensures consistency with the treatment required by the IRS for direct repayments. But while safe, it is not entirely certain that it is required.

Section 409A adds a wrinkle for clawbacks enforced by being held back from nonqualified deferred compensation. To avoid potential section 409A pitfalls, those holdbacks should be included in the gross income reported on the forms W-2 or 1099, for reasons detailed in Part V (relating to former employees).

Assuming that the repayment is included in the employee's Forms W-2 gross income and wages (rather than netted or excluded), and assuming the employer claimed a deduction for the original payment, the employer must take the repayment back into income.

Retroactive clawbacks — special issues. Some companies may want to apply their new clawback policies, or broaden an existing policy, retroactively to compensation first paid in a year before the year the clawback policy was adopted (or broadened). Part II discusses whether the employee may claim a deduction for these retroactive clawbacks. It concludes that — despite some troublesome authorities — the employee can likely claim an itemized deduction under section 162 or 165(c)(1). Somewhat more problematic is the make-whole deduction or credit under section 1341. The current IRS position is not entirely clear and might preclude section 1341. The theory of controlling case law, however, should allow section 1341 treatment for many or most retroactive clawbacks.

'Bad boy' clawbacks — special issues. Part III discusses clawbacks imposed when an employee or former employee breaches an employment or severance agreement — for example, a covenant not to compete — or engages in other detrimental conduct. (By contrast, clawbacks triggered by a financial restatement, including Dodd-Frank clawbacks, may be imposed even absent personal wrongdoing.) These clawbacks are deductible by the employee. The availability of section 1341 treatment is more doubtful. Again, the (apparently current) IRS

Bonuses: Easy; Getting Tax Deductions: Priceless,'' *Tax Notes*, Apr. 13, 2009, p. 185, *Doc 2009-6858*, or *2009 TNT 69-8*.

standard would arguably deny section 1341 treatment, while the controlling case law would allow it. In rare and egregious situations in which the clawback is triggered by criminal behavior, the "claim-of-wrong" rule may preclude section 1341.

Retirees and other former employees — section 409A and other special issues. Part IV discusses clawbacks enforced against former employees. Although the authorities are sparse, former employees should be able to deduct clawbacks under section 165(c)(1) and also claim section 1341 treatment to the same extent as current employees. If the employer enforces the clawback by holding back the amount from nonqualified deferred compensation, possible violations of the substitution rule of the section 409A regulations arise. The suggested way to avoid this section 409A pitfall, flagged in Part I but explained here in Part IV, is to include the held-back amounts in the wages and gross income reported on the Form W-2 (or Form 1099).

Employer stock — special issues. Part V addresses clawbacks of bonuses paid as employer stock or other property subject to section 83, in particular issues raised by any appreciation or depreciation of the property since the date it was included in income.

FICA taxes. Part VI addresses the procedures for unwinding FICA taxes on clawed-back amounts. FICA taxes on the original payment — both the employer's and employee's share — can be recouped under IRS procedures for mistaken overpayments. This is so even though the original payment was correct when first made and was only later determined to be an "overpayment" via imposition of the clawback. The employee must repay the entire "overpayment" (the clawed-back amount) to the employer. It is not entirely clear whether the "overpayment" amount must be computed on a gross basis or may be net of FICA taxes originally withheld. Recent IRS guidance, however, suggests that repayment of the original payment is permitted net of the original FICA taxes.

Practical conclusions: What to do. Part VII summarizes the practical conclusions for employers and their advisers attempting to fashion a comprehensive and enforceable policy for clawbacks and their correct tax treatment.

I. General Tax Treatment of Clawbacks

This part discusses the general tax treatment of clawbacks before later sections address the specific issues raised by retroactive clawbacks, clawbacks enforced against former employees, clawbacks of stock and other property, and special FICA tax issues raised by clawbacks.

A. Repayment in Same Year as Payment

In the rare case, compensation will be repaid in the same year as originally paid. This case is governed by the simplest rule. Under Rev. Rul. 79-311, the repayment amount is treated for tax purposes as if never paid.[3] The employer reports the employee's wages and income on the employee's Form W-2 for the year net of the repayment amount. The repayment is excluded from wages and gross income regardless of whether the repayment is held back from other wages or paid directly by the employee (say, by writing a check). The IRS's position on repayments in the same year as the original payment is grounded on the seminal cases of *Couch v. Commissioner* and *Russel v. Commissioner* and their numerous progeny.[4] Later IRS guidance has consistently followed the position set forth in Rev. Rul. 79-311 for amounts repaid in the same year as paid.[5]

B. Repayments of Previous Years' Payments

More typically, a clawback will require repayment of compensation first paid in an earlier year. Assume, for example, that the employer adopts a clawback policy in 2009. In the next year the employee receives a performance bonus for 2010, but in 2012 the policy requires that he repay the performance bonus originally paid in 2010.

The employee in this example is not permitted to amend his income tax return for 2010, the year the bonus was originally paid. Under the long-standing claim of right doctrine, the payment remains in the employee's taxable income for the year of receipt even though it must be returned in a later year.[6] The doctrine applies even assuming that the employee's original right to the bonus was contingent because it was subject to a preexisting clawback policy,[7] and

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[3]Rev. Rul. 79-311, 1979-2 C.B. 25.

[4]*Couch v. Commissioner*, 1 BTA 103 (1924), *acq*. IV-1 C.B. 1 (1925); *Russel v. Commissioner*, 35 BTA 602 (1937), *acq*. 1937-1 C.B. 22. For a detailed discussion of *Couch*, *Russel*, and their progeny, see Rosina B. Barker and Kevin P. O'Brien, "409A Failures: Correcting With and Without Notice 2008-113," *Tax Notes*, Aug. 10, 2009, p. 557, *Doc 2009-15829*, or *2009 TNT 151-8*.

[5]*See also, e.g.*, LTR 200044007 (July 26, 2000), *Doc 2000-28297*, *2000 TNT 215-20*; LTR 9313015 (Dec. 23, 1992), *93 TNT 75-29* (under Rev. Rul. 79-311, lump sum relocation advance repaid in same year excludable from gross income and wages reported on employee's Form W-2); LTR 8422130 (Feb. 29, 1984) (when advances received by physicians and repaid to hospital by year-end to the extent in excess of guaranteed amounts, *held*, advances not included in gross income and wages reported on Form W-2 to the extent returned in the same year as received under *Couch*, *Russel* and Rev. Rul. 79-311).

[6]*North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

[7]*See, e.g., McCormack v. Commissioner*, T.C. Memo. 1987-11 (when advance fees received subject to contingent repayment obligation if payee fired by payer during two-year period, *held*,

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even assuming the bonus was originally paid under a mutual mistake of fact.[8]

The threshold question is whether the repayment may be excluded from (netted against) wages and gross income reported on the employee's Form W-2 for 2012 (the repayment year). Or must the employer include the employee's repayment in the wages and gross income reported on the employee's Form W-2 for that year? In this case, the employee could reverse the income tax previously paid on the relinquished amount only to the extent he can claim the repayment as a deduction, subject to any applicable deduction limitations.

1. Direct repayments: No exclusion from gross income. The IRS staked out its position on the tax treatment of repayments in Rev. Rul. 79-311. If compensation is originally paid in one year and repaid in a later year, the employer may not exclude the repayment from the gross income and wages reported on the employee's Form W-2 in the repayment year. The employee may deduct the repayment to the extent permitted by section 162(a) or 165(c)(1), subject to the 2 percent floor and the AMT, and in some cases claim section 1341 relief from those two limitations. The IRS has followed this position consistently for repayments of earlier years' payments, at least when repayment is made directly rather than held back from other compensation.[9]

2. Repayments held back from later compensation. In many cases clawbacks will be enforced by being held back from other payments of compensation. Holdbacks can be consensual — for example, the employer might offer the employee a choice between writing a check and taking a corresponding cut in pay or bonus. Or they can be imposed unilaterally or involuntarily by the employer to enforce otherwise doubtful repayment. State wage payment laws may limit involuntary holdbacks, particularly against base pay, but depending on the state, may permit them against severance pay, bonuses, stock options, or equity-based plans.[10]

a. Tax treatment of holdbacks generally. Surprisingly, the tax treatment of those holdbacks is not entirely clear, and the authorities not entirely consistent. One approach would follow Rev. Rul. 79-311. Under that approach, held-back amounts would be included in the gross income and wages reported on the employee's Form W-2 (or Form 1099), even though not paid directly to the employee. Just as for direct repayments, the employee could claim the holdback as a deduction under sections 162 or 165, and claim section 1341 treatment when applicable.

Gross income inclusion for holdbacks is indirectly but strongly supported by considerations of consistency. It makes their tax treatment identical to that required by Rev. Rul. 79-311 for direct repayment, thus observing the substance-over-form doctrine.[11] At least one private letter ruling has required gross income inclusion for holdbacks. LTR 9103031 involved an employer who recouped mistaken overpayments of bonuses paid in a prior year by holding back the overpayments from salary

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advance taxable under claim of right); *Phillips v. Commissioner*, T.C. 767, *aff'd*, 238 F.2d 473 (7th Cir. 1956) (contingent attorney's fees taxable under claim of right, even though change in law in year of payment made repayment likely in later year).

[8]*See, e.g., United States v. Lewis*, 340 U.S. 590 (1951).

[9]Rev. Rul. 79-311, 1979-2 C.B. 25 (when advances paid to employees exceeded earned commissions and were repaid on termination of employment under a contact agreement, *held*, when repayments are made in a year after the year the advance was first paid, the employer may not report the repayment as a reduction from gross income and wages reported on the employees' Forms W-2 for the repayment year; the employee can claim a deduction for the repayment under section 162(a)(1) and can also claim credit for the employee's share of FICA taxes withheld from the advance under reg. section 31.6413(a)-1(b)(i)); GCM 36851 (Sept. 17, 1976) (general counsel memorandum underlying Rev. Rul. 79-311, reaches same conclusions but suggests that a deduction for repayment is available under either section 162(a) or 165(c)(1)); 2001 IRS CCA Lexis 302 (June 15, 2001) (when bonuses paid in an earlier year were repaid in a later year in accordance with a settlement of civil litigation, *held*, there is "no exclusion from income in the year repaid"; the employee can offset taxes on previously received amounts only by claiming a deduction for repayment); LTR 200044007; LTR 9313015 (when a lump sum relocation advance was repaid in later year on voluntary termination according to an agreement in force at the time the advance was paid, *held*, the repayment is deductible in accordance with Rev. Rul. 79-311); LTR 9103031 (Oct. 23, 1990), *91 TNT 17-78* (in which bonus overpayments mistakenly paid to some employees in one year and repaid in

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the subsequent year by being held back from salary payments, *held*, under Rev. Rul. 79-311, the setoffs were included in the income and wages reported on the affected employees' Forms W-2 for the year, rather than excluded from section 61 gross income; the affected employees could claim an itemized deduction for held-back amounts, subject to the 2 percent floor, etc.).

[10]For a discussion of the variety of constraints imposed by state wage laws, as well as other nontax issues raised by clawbacks, see Richard E. Wood, "Bad Boys (and Girls) Get Clawed Back," 18 *Benefits L. J.* 84 (2005).

[11]*See, e.g., Adams v. Commissioner*, 58 T.C. 41 (1972). (When an advance was repaid by reducing consideration within a section 337 liquidation sale between the parties, the court rejected the IRS's argument that no deduction was available, reasoning that while the "mode of repayment" was a reduction of consideration in the sale, the "source" of the reduction was an obligation to repay the advance, and it was therefore deductible under section 162. The court further explained: "It is as much an out of pocket payment by the taxpayer as if he had used other available cash and on his own initiative refunded the unused amounts due the less. It is the substance of the economic relationship, not the form in which it is cast, that determines the incidence of Federal income tax.")

otherwise payable in the repayment year.[12] The IRS ruled that under Rev. Rul. 79-311 the held-back amounts should be included in the income and wages reported on the employees' Forms W-2 (and claimed by the employees as itemized deductions to the extent permitted by the 2 percent floor, etc.).

The IRS is not entirely consistent, however, in its required tax treatment of holdbacks. Rev. Rul. 2002-84 deals with retirees' repayments of overpayments from a qualified defined benefit plan. Rev. Rul. 2002-84 holds that when a retiree receives a mistaken overpayment in one year and repayment to the plan is made by reducing later years' distributions, the holdbacks are excluded from the gross income reported on the retiree's Form 1099.[13] The IRS here rules that exclusion is appropriate even though the retiree had personal liability to repay and could apparently repay the overpayment directly by writing a check, deductible under section 165(c)(2).[14]

Moreover, the IRS and the courts seem to agree that holdbacks are excluded from gross income when the employee otherwise has no personal repayment liability. For example, *Drummond* and *Moorman* involved employees who were contractually required to repay their employer unearned advances of commissions by having the unearned amounts held back from commissions earned in a later year.[15] If the unearned advances exceeded the later year's earned commissions, the employees had no personal obligation to pay the difference. The Tax Court held that the holdbacks were excluded from the wages and gross income reported on the employees' Forms W-2. Since the advances were included in income when first paid, the Tax Court concluded that it followed that they were not again taxed when held back as repayment. The IRS acquiesced in *Moorman*. Similarly, at least two IRS revenue rulings have dealt with military personnel who received post-termination pay and, when later entitled to additional post-termination benefits, were required to repay the earlier amounts via holdback from the later-paid amounts.[16] Both Rev. Rul. 80-9 and Rev. Rul. 67-530 concluded that the repayments held back from the later-paid amounts were excluded from the payee's section 61 gross income (rather than included in gross income, subject to deduction).[17]

It is difficult to reconcile these authorities. Surprisingly, it is even more difficult to identify a convincing theory explaining why holdbacks to repay previously taxed compensation should *ever* be included in gross income (as under LTR 9103031) rather than excluded (as under *Moorman*, *Drummond*, and rev. ruls. 2002-84, 80-9, and 67-530). In concluding that the holdbacks were excludable, the *Drummond* court apparently reasoned that the repaid amounts (which were taxed when first paid) would otherwise be taxed twice. Under this apparent double taxation concern, all repayments of previously taxed payments would be excludable from gross income, at least when held back from other compensation.[18]

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[12]LTR 9103031 (Oct. 23, 1990).

[13]Rev. Rul. 2002-84, 2002-2 C.B. 953, *Doc 2002-26400*, *2002 TNT 230-1*, situations 1 and 2 (when an erroneous overpayment of qualified defined benefit plan benefits was repaid by being set off from later-years' scheduled annuity payments, *held*, the setoff amount each year was properly netted from distribution reported on the retiree's Form 1099 for that year, rather than included in gross income).

[14]Rev. Rul. 2002-84, *supra* note 13, Situation 3 (in which a retiree received an overpayment of a lump sum and the overpayment was repaid directly by the retiree in subsequent year, *held*, the repayment was deductible under section 165(c)).

[15]*Drummond v. Commissioner*, 43 BTA 529 (1941) (when an employer held back commissions earned in one year to recoup unearned advances of sales commissions paid in an earlier year, and the taxpayer had no personal liability to repay the advances, *held*, the amount of holdback was not included in the taxpayer's gross income, reasoning that, because the advances were included in income in an earlier year under claim of right, it would follow that they are not includible in income in the later year when held back); *Moorman v. Commissioner*, 26 T.C. 666 (1966), *acq.*, 1956-2 C.B. 7 (similar, citing *Drummond*).

[16]Rev. Rul. 80-9, 1980-1 C.B. 11 (when lump sum readjustment pay was repaid via a holdback from later-paid disability pay, *held*, readjustment pay netted from the disability pay must be reported in gross income); Rev. Rul. 67-530, 1967-2 C.B. 58 (when a military officer's retirement pay was, by statute, offset by 75 percent of any earlier-paid involuntary severance pay, *held*, the retirement pay was includible in gross income only net of the setoff).

[17]Recall Rev. Rul. 2002-84, *supra* note 13, situations 1 and 2, holding that, when overpayments from a qualified plan are repaid by being held back from later year's distributions, the amounts held back are excluded from gross income reported on the retiree's Form 1099. Rev. Rul. 2002-84 based its holding on the two military pay revenue rulings discussed *supra* note 16. Rev. Rul. 2002-84, however, extended the holdings of those two earlier revenue rulings to a broader set of facts. The retiree in Rev. Rul. 2002-84 had a personal liability to repay the pension overpayment if later years' pension distributions were insufficient to cover it.

[18]*Cf. Aramony v. United Way*, 86 AFTR.2d 5987 (S.D.N.Y. 2000), *Doc 2000-23631*, *2000 TNT 179-12*. An ousted executive and United Way, his former employer, simultaneously owed amounts to each other from previous years in accordance with long-running litigation. The district court held that, for income tax withholding purposes, United Way was required to compute its payments to the executive *net* of the salary clawbacks required to be repaid by the executive to United Way in the same year. Like the *Drummond* and *Moorman* courts, the *Aramony* court based its holding on the reasoning that the executive's repaid salary would otherwise be subject to double taxation. *Aramony* is poorly reasoned, however, and it is unclear whether it applies beyond its specific facts.

In GCM 36851 the IRS suggested a different rationale for the *Drummond* and *Moorman* holdings, a rationale explaining the IRS's contrasting income-inclusion approach for the holdback in LTR 9103036.[19] GCM 36851 in dictum reasoned that taxpayers in both cases "never received nor had the right to receive" the setoffs used to repay the advances.[20] While not entirely clear, the GCM apparently reasons that if the taxpayer can elect to satisfy a repayment obligation from his other resources — like the Rev. Rul. 79-311 taxpayers and unlike the *Drummond* and *Moorman* taxpayers — he is in constructive receipt of amounts held back from compensation to satisfy an obligation payable at his election from other, after-tax resources. This putative constructive receipt rationale explains the IRS's different treatment of the holdback in LTR 9103031 (income inclusion with deduction) and rev. ruls. 80-9 and 67-530 (income exclusion). But constructive receipt doctrine is ultimately unsatisfactory when explaining income inclusion for holdbacks; it begs the threshold question whether the holdback is a simple cancellation of this year's pay or the continued right to unreduced pay coupled with the obligation to repay a portion of the prior year's pay.[21] In any event it falls apart as a technical matter.[22]

Alternatively, holdbacks to enforce a clawback obligation could be viewed as a taxable cancellation of indebtedness. This theory also fails to support income inclusion. The original payments were included in income because they were received under a claim of right and not as excludable indebtedness.[23] And even assuming that the springing clawback obligation, and not the original payment, gives rise to "indebtedness,"[24] direct repayment of the clawback is deductible under section 162 or 165. Cancellation of the purported indebtedness would be excludable from gross income under section 108(e)(2).[25]

A third possible theory is that the amounts held back to satisfy the employee's repayment obligation to the employer are a taxable assignment of income from the employer to the employee under the doctrine of *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940). This argument is unsatisfactory, too, because the assignment of income doctrine apparently does not apply in the two-party context such as this one between employer and employee.[26]

This difficulty in articulating a theory governing the tax treatment of holdbacks may stem from the fact that compensation paid in one year can be for services performed over many years during the entire service relationship. Thus, a bonus may reward an employee for services performed in an

[19]GCM 36851 (Sept. 17, 1976). GCM 36851 underlies Rev. Rul. 79-311.

[20]This fact was irrelevant to the *Drummond* and *Moorman* courts' treatment of the repayment. The *Drummond* opinion noted that the taxpayer had no personal liability to repay the advance. That fact was relevant only to the taxation of the *original* payment, not the repayment. Because the taxpayer had no personal liability to repay the advance, the court concluded the advance was properly included in income under a claim of right when first paid, and, because includable when first paid, properly excludable when repaid to avoid double taxation. GCM 36851 turned the *Drummond* logic on its head. Because the taxpayer had no "right to receive" the setoffs, the memorandum concluded that they were properly excludable from income. GCM 36851 thus stretched the court's reasoning (payment included in income when paid is therefore excluded when repaid) to an unrelated conclusion (repayment is excludable regardless of the treatment of the original payment).

[21]The fundamental problem is that the constructive receipt doctrine *cannot* answer this question, because the doctrine properly applies only to determine the *timing* of income receipt — whether amounts owing to the taxpayer may be properly deferred for tax purposes. *See* reg. section 1.451-2(a) (under the doctrine of constructive receipt, an individual is in receipt of income for tax purposes in the tax year it is credited to him or made available to him). For an excellent discussion of the proper purposes of the various income receipt theories, see Patricia A. Metzer, "Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation," 29 *Tax Law Rev.* 525 (1974). The doctrine does not apply to the issue, raised here, whether income is received in the first instance.

[22]Constructive receipt, for example, does not apply to income deferred under an election made before the year the income is earned. *See, e.g.*, Rev. Rul. 60-31, 1960-1 C.B. 174; GCM 37014. Consider Rev. Rul. 79-311, when unearned advances were required to be paid according to a preexisting agreement. Even if applicable to waivers as well as deferrals of income (which is not the case), the doctrine would not apply if, under that agreement, the first dollar of commissions earned in the later year was reduced to repay the prior year's unearned advances.

(Footnote continued in next column.)

[23]*See, e.g.*, *Lehew v. Commissioner*, T.C. Memo. 1987-389 (advances intended as loans and subject to unconditional personal obligation on part of recipient to repay are not taxable by cash method taxpayer when paid, but become taxable when they are earned and offset against outstanding advances).

[24]*Cf. Violette v. Commissioner*, T.C. Summ. Op. 2002-149 (when a taxpayer received insurance proceeds and was later required to return them because the insurer determined that the amounts were received under a false pretense, *held*, debt was created, and the insurer's decision that collection would be futile created debt cancellation income under section 108(a)).

[25]As discussed below in this report, for bonuses repaid under a clawback policy first imposed after the bonuses were paid (retroactive clawbacks), a deduction may not be available under section 162 or 165. In that case, however, repayment would not be indebtedness, and its "cancellation" via holdback would not be subject to section 108(a). *See, e.g.*, *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990) (cancellation of a gambling debt is not taxable under section 108(a) when the gambling debt is not enforceable under state law).

[26]*See, e.g.*, Kevin P. O'Brien and Rosina B Barker, "Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion After *Express Oil Change*," 12 *Benefits L. J.* 1 (1999).

earlier year and retrospectively viewed as underpaid. This same principle is recognized for income tax purposes, despite the general primacy of annual income accounting. It has long been held that compensation paid in one year is not unreasonable — and is therefore deductible under section 162 for that year — if paid for earlier years' services for which the employee was underpaid. *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930). See also, for example, *Brewer Quality Homes, Inc. v. Commissioner*, T.C. Memo. 2003-200 (2003), *Doc 2003-16457*, *2003 TNT 133-6*; *Sunbelt Clothing Co. v. Commissioner*, T.C. Memo. 1997-338 (1997), *Doc 97-22024*, *97 TNT 145-12*. When compensation is viewed as applying to the entire multi-year service relationship, then, when a clawback of year 1 compensation is satisfied by reducing year 2 compensation, it is not entirely clear that the year 1 compensation was "repaid." Rather, it could just as plausibly be said that year 2 compensation was reduced to adjust for what, in hindsight, was overpayment of year 1 compensation. Seen through the first or "repayment" lens, the reduction in year 2 compensation may appropriately be treated under the income inclusion/deduction approach of Rev. Rul. 79-311. But seen through the second, or multi-year service relationship lens permitted by *Ox Fibre Brush* and its offspring, the reduction in year 2 compensation should simply be excluded from income and wages — like any other pay cut. This conceptual ambiguity of what the year 2 pay cut means may explain a dearth of guidance on this subject.

b. Section 409A and holdbacks from nonqualified deferred compensation. Some clawbacks may be enforced by being held back from payments of nonqualified deferred compensation. For example, the employer's clawback policy might state that a performance bonus granted in one year will be clawed back by nonpayment of bonuses payable in a later year, when those later bonuses are nonqualified deferred compensation.[27] The overly broad substitution rule of the section 409A regulations raises possible section 409A compliance issues for those setoffs on two counts. First, if the employer's policies or agreements anywhere state that the original payment of compensation may be clawed back by being held back from later payments of deferred compensation, the original payment is conceivably a prohibited substitution of the later-payable deferred compensation.[28] Also, the holdback itself could be a section 409A violation because it was arguably paid in "satisfaction of a debt of the service provider to the service recipient" in excess of $5,000.[29]

To avoid those two potential section 409A issues, any amount held back from payments of nonqualified deferred compensation should be included in the gross income and wages reported on the employee's forms W-2 or 1099 for the year (except, of course, to the extent reported in an earlier year as FICA wages under section 3121(v)(2)). That is, complying with Rev. Rul. 79-311 fortunately appears to avoid section 409A noncompliance as well. The justification for this solution (as well as a more detailed explanation of why this is a problem in the first place) is set forth in Part IV, relating to former employees.

c. Practical summary: Tax treatment of holdbacks. In short, the tax treatment of repayments held back from other compensation is subject to some confusion. The employer may find the practical arguments compelling for complying with the income-inclusion position of Rev. Rul. 79-311 for all repayments of amounts received in a prior year, including repayments made by holdback. The tax risk of taking the contrary position falls largely on the employer: Failure to report a holdback as Form W-2 wages and income exposes the employer to underwithholding tax and penalties on the held-back amounts. The employee can in most cases reverse any income taxes previously paid on the relinquished payment by claiming the repayments as a deduction under section 162 (or section 165(c)(1)), as well as section 1341. For some repayments, of course, Rev. Rul. 79-311 may have harsh employee results because the employee bears some risk that section 162 or 165 — and especially section 1341 relief from the burdensome 2 percent floor and the AMT — will be unavailable. (See Part II for issues raised by retroactive clawbacks under all three code provisions, and Part III for issues raised by bad boy clawbacks under section 1341.) For amounts held back from nonqualified deferred compensation, compliance with Rev. Rul. 79-311 avoids a potential section 409A pitfall created by the substitution rule of the section 409A regulations.

[27]For example, consider a bonus paid as a performance stock unit (PSU) that vests or partly vests in the year of grant but pays out only three years after the grant. The PSU is nonqualified deferred compensation subject to section 409A.

[28]Reg. section 1.409A-3(f) (prohibiting payments that "result in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation").

[29]Reg. section 1.409A-3(j)(4)(xiii) (stating that a plan may provide for the acceleration of payment, "satisfaction of a debt of the service provider to the service recipient," up to an amount of no more than $5,000 (for all years)).

3. Itemized deductions — availability and mechanics. Assuming that the employer strictly complies with the IRS's position in Rev. Rul. 79-311, the repayment is included in gross income and wages reported on the employee's Form W-2 even if held back from compensation payable during the year. In that case, the employee may generally claim a deduction for the repayment.

Under what section is the deduction claimed? It is well established that a taxpayer can be in the trade or business of being an employee.[30] An employee can thus claim a deduction for repayments of earlier-paid compensation, either as an unreimbursed business expense under section 162[31] or as a loss incurred in trade or business under section 165(c)(1).[32] In any event, the question has no practical significance. Whether claimed under section 162 or 165, the deduction is bound by identical constraints.[33]

In addition to the availability of sections 162 and 165(c)(1), some early case law appears to treat section 1341 as an independent ground for deducting repayments of amounts received in an earlier year. Those cases are to that extent incorrectly reasoned because section 1341 is available only for repayments for which a deduction is already allowed under some other code section.[34]

Whether claimed under section 162 or section 165(c)(1), the deduction may be taken only below the line as a miscellaneous itemized deduction, subtracted from adjusted gross income by a taxpayer who does not claim the standard deduction. Under section 67, the deduction may be claimed only to the extent that, with other miscellaneous itemized deductions, it does not exceed 2 percent of the taxpayer's AGI (the 2 percent floor). Whether the deduction is claimed under section 162 or section 165(c)(1), the 2 percent floor applies, and the deduction may not be taken against the taxpayer's AMT.[35]

Accordingly, the employee may be unable fully to reverse income taxes previously paid on the relinquished compensation even if the repayment is deductible, unless the employee can also use the favorable claim of right credit or deduction under section 1341.

4. Section 1341 make-whole treatment — purpose and mechanics. Section 1341 was enacted in response to the common-law claim of right doctrine. The doctrine provides that if a taxpayer receives a payment "under a claim of right and without restriction as to its disposition," the payment is includable in gross income in the year received, even if repaid in a later year.[36] Section 1341 allows the repaying taxpayer to compute income tax in the repayment year as the *lesser* of (1) the tax computed by claiming the repayment as a deduction for that year or (2) the tax computed without the deduction, but reduced by a tax credit equal to the income tax attributable solely to the payment in the tax year it was received.

This "lesser of" treatment makes the mechanics of section 1341 complex.[37] In making the first benchmark computation, the employee deducts the repayment without regard to the otherwise applicable 2 percent floor.[38] In making the second benchmark computation, the employee recomputes income tax for the year of initial payment as if the repaid amount had never been received. This hypothetical treatment applies to all taxes under Title I, including the AMT.[39] The 2 percent floor, of course, does not apply because the recomputation is an income exclusion rather than a deduction. (That is, both the first and second benchmarks are computed without the 2 percent floor.) If the second, "as-if" benchmark computation yields a better tax result than the first, the employee claims the as-if tax reduction as a credit. If the credit exceeds taxes owed for the repayment year, the excess is a refundable credit.[40]

[30] *O'Malley v. Commissioner*, 91 T.C. 352, 363-364 (1988).

[31] *See, e.g.*, *Adams*, 58 T.C. 41; Rev. Rul. 79-311.

[32] *See, e.g.*, GCM 36851 (underlying Rev. Rul. 79-311, the memorandum reaches the same conclusion but would allow repayment to be deducted under either section 162(a) or 165(a)(1)); Rev. Rul. 82-178, 1982-2 C.B. 59 (repayment of severance by a rehired employee is deductible under section 165(a)(1) as a loss incurred in the employee's trade or business); Rev. Rul. 79-322, 1979-2 C.B. 76 (amounts paid by federal employee repurchase sick leave pay received in an earlier year are deductible under section 165(a)(1)); Rev. Rul. 67-48, 1967-1 C.B. 50 (when an employee who repaid wages received in an earlier year as liquidated damages for breach of a contract in effect when the wages were initially paid, *held*, repayment deductible under section 165); Rev. Rul. 2002-84, *supra* note 13 (when qualified pension plan makes erroneous overpayment to a retired employee and the employee repays directly in later year, the repayment is deductible under section 165(a) because "the amount of the plan overpayment is attributable to compensation for services rendered to the employer").

[33] As discussed below, both are subject to the prohibition against deduction of voluntary payments, the 2 percent floor for miscellaneous itemized deductions under section 67, and the AMT.

[34] Section 1341(a)(2); *United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969).

[35] Section 56(b)(1)(A)(i).

[36] *North American Oil Consolidated v. Burnet*, *supra* note 6.

[37] It also complicates the terminology. Section 1341 is typically shorthanded as a "deduction," although, as may be seen here, it also operates as a credit.

[38] Section 67(a)(9); SCA 1998-026 (Dec. 23, 1998), *Doc 98-36964*, *98 TNT 250-46*.

[39] FSA 200129001 (Mar. 20, 2001), *Doc 2001-19611*, *2001 TNT 141-9*.

[40] Reg. section 1.3401-1(i).

As already noted, section 1341 does not independently authorize deductions, but applies only to payments already deductible under another code section. Thus, technically, the employee first determines that the clawback is deductible under sections 162 or 165, and only then may determine whether section 1341 is available.

5. Section 1341 and the evolving IRS position. As we show below, the executive can confidently claim section 1341 treatment for clawbacks, at least for repayments of compensation first paid *after* the clawback policy was adopted. (Retroactive clawbacks are more problematic, as discussed in Part II.) This is worth some discussion because the IRS position on this point has evolved over the decades. While still not entirely clear, the current IRS position may not yet completely line up with prevailing case law, which, as we also show below, should allow section 1341 treatment for many or most clawbacks.

a. Statute: Two-pronged test. Section 1341 applies if the repayment exceeds $3,000 and two requirements are met: It appeared that the taxpayer had an unrestricted right to that amount in the year of receipt (section 1341(a)(1)), and it was established after the close of that year that the taxpayer did not have an unrestricted right to the item (section 1341(a)(2)). Each of the two prongs under section 1341(a)(1) and (a)(2) has been subject to evolving interpretation.

b. Former IRS position: Subsequent events test. Early IRS guidance held that when amounts are repaid under a contingency that ripened after the year of the original payment, the repayment is ineligible for section 1341 treatment, even if the contingency was in place when the amounts were earned. The IRS reasoned that in those cases, the initial payment was originally held under an actual right rather than an ''apparent'' right, as required under section 1341(a)(1). For example, Rev. Rul. 69-115 involved an employee-shareholder who returned earlier years' salary to his employer (the corporation of which he was a shareholder) under an agreement, entered into before the salary was paid, that the salary would be repaid if the IRS later determined it was nondeductible as unreasonable compensation under section 162. The ruling held that the repayment was ineligible for section 1341 treatment (even though deductible under section 162), because the taxpayer had an unrestricted right to the amounts when paid and the repayment obligation was caused only by a ''subsequent event'' — that is, the IRS's later administrative determination.[41] Many earlier rulings applied the subsequent event test in a similar way.[42]

Under this early (and now superseded) IRS position, an employee could not claim section 1341 treatment for a clawback, even if the clawback policy was adopted before the compensation was originally paid. The repayment trigger — be it an earnings restatement, violation of a noncompete covenant, or other event — would be a ''subsequent event'' because it would be determined only after the year of the original payment.

In *Van Cleave*, the Sixth Circuit rejected the IRS's subsequent event test.[43] The *Van Cleave* taxpayer's salary was earned subject to a preexisting agreement to repay if the IRS later concluded the salary was nondeductible under section 162. The Sixth Circuit reasoned that even though the salary's nondeductibility was not determined until the occurrence of a subsequent event (the IRS administrative

[41]Rev. Rul. 69-115, 1969-1 C.B. 50 (employee-shareholder who returned earlier years' salary to the employer (the corporation of which he was a shareholder) under an agreement, in effect when the salary was paid, that the salary would be repaid if later determined by the IRS to be nondeductible. Citing Rev. Rul. 67-48, the ruling that (i) the repayments were deductible under section 162(a)(1) (because repaid under an obligation in existence when earned) but (ii) section 1341 was not available because the repayments were made on a subsequent event (the IRS's nondeductibility determination).

[42]Rev. Rul. 67-437, 1967-2 C.B. 296 (when salary earned in one year is repaid to the employer in a later year under an agreement that repayment would be made if amounts determined by the IRS to be nondeductible, *held,* section 1341 treatment was not available because taxpayer had an ''unrestricted right'' in the year of receipt, and the repayment obligation was triggered by a subsequent event); Rev. Rul. 67-48, 1967-1 C.B. 50 (when excess wages, initially paid in expectation of an employee's serving for a contractually agreed service period, are repaid to the employer as liquidated damages by the employee for breach of the service contract, *held*, the payment is deductible under section 165(c)(1), but section 1341 is unavailable because the employee in fact had a right to those excess wages when they were received; repayment caused by the ''subsequent event'' — the breach). Rev. Rul. 58-226, 1958-2 C.B 318 (when there was a refund of prepaid interest on a 10-year note and prepayment of the principal was made in a subsequent year, section 1341 was not available, because the taxpayer ''in fact and in law'' had a right to the money when received, instead of an ''appearance'' of a right as required by section 1341(a)(1). The section 1342(a) requirement that the absence of a right in the prior year be ''established after the close'' of the year was not met, because the liability to repay ''accrued'' in a later year); the taxpayer had an unrestricted right to prepaid interest, and the repayment obligation was triggered by subsequent event (namely prepayment of principal); Rev. Rul. 68-153, 1968-1 C.B. 371; Rev. Rul. 67-48, 1967-1 C.B. 50.

[43]*Van Cleave v. United States*, 718 F.2d 193, 196 (6th Cir. 1983), *rev'g sub nom. Van Cleve* [sic] *v. United States*, 82-1 U.S.T.C. (E.D. Mich. 1981).

determination), it did not follow that the taxpayer had an unrestricted right to the compensation when he received it.

c. More recent IRS position: Facts-in-existence test. The IRS seems to have abandoned the rejected subsequent event test after *Van Cleave.* Its newer thinking is that a taxpayer can claim section 1341 treatment for a repayment if the facts in existence at the time of the original payment would trigger the contingency — even though those facts are not ''known'' until a later year.

In developing the facts-in-existence test, the IRS apparently tried to fashion a section 1341 theory consistent both with *Van Cleave* and with the Service's long-held distinction between the ''apparent'' and ''actual'' right to the initial payment. For example, in discussing the test as applied to the *Van Cleave* facts, the IRS reasoned that even though the determination that the taxpayer's salary was unreasonable was not made until a later year, ''the excessiveness of the salary was a fact in existence (although unknown) in the year it was received.'' Because of the facts in existence at the time of the initial payment, the *Van Cleave* taxpayer's right to the payment was only apparent, rather than actual, at the time received, in compliance with both section 1341(a)(1) and (a)(2).[44]

d. Clawbacks under the IRS's facts-in-existence test. The facts-in-existence test comfortably extends section 1341 treatment to some but not all clawbacks.

For Dodd-Frank and similar clawbacks based on earnings restatements, section 1341 should apply if the clawback policy preexisted the original payment. Assuming that the company's ''real'' financial position and the employee's contingent repayment obligation are both facts in existence when the bonus was originally paid, the logic of the test applies.

For clawbacks in other situations, the test is less certain. An example is compensation paid before the clawback policy is in place. The contingent repayment obligation is not a fact in existence at the time of the payment. Another example is bad boy clawbacks, such as a clawback of severance pay for breach of a noncompete agreement. The facts in existence (the breach) might not arise until sometime after the payment. In both cases, the employee receives the payment under an actual right, rather than, as required by section 1341, only an apparent right, and under the IRS's reasoning, section 1341 might not apply.

e. Problems with the IRS's facts-in-existence test. The problem is that the facts-in-existence test is somewhat of a conceptual muddle (which may explain its rejection by the courts, as shown below). First, it is grounded in the IRS's attempt to distinguish between an apparent right (to which section 1341 applies) and an actual right (to which it does not). This distinction fails to convince, because the logical understanding of ''actual'' rights is that they are a subset of apparent rights, that is, those rights that are apparent because they are in fact true.[45]

Second, the test tries to identify a world where the facts at the time of payment, if known, would justify repayment; only the requisite knowledge is lacking. This distinction also crumbles. The ''facts'' compelling a repayment must always be a mix of initial circumstances and later administrative or legal determinations. In the unreasonable-compensation cases, for example, the ''fact'' is the payment of compensation. But the amount of payment is not in fact ''unreasonable'' until so determined by the IRS or a court. The difference between the facts in existence at the time of payment and those arising later must collapse on inspection.

The IRS has not formally abandoned its facts-in-existence test and its underlying distinction between actual and apparent right to income under section 1341. It is unclear, however, whether the IRS would still insist on its former position in light of the case law discussed below.

f. Backup IRS position: 'Voluntary' test. The IRS has indicated that a second argument might deny section 1341 treatment to repayments made under a retroactively imposed payment condition, namely, the argument that those repayments are voluntary. The statutory source of this ''voluntary'' argument

[44]TAM 9516002 (Apr. 21, 1995), *95 TNT 79-13* (explaining that *Van Cleave* is not a repudiation of the subsequent-event test, because although the determination that the salary was excessive was not made until a later year, ''the excessiveness of the salary was a fact in existence (although unknown) in the year it was received.'' Accordingly, the taxpayer's return of salary was not caused by a ''subsequent event''); Rev. Rul. 72-78, 1972-1 C.B. 45 (when salesman receives advance commissions but repays a portion in a later year because some customers failed to pay their obligations, *held*, repaid amounts are deductible under section 162 and eligible for section 1341 treatment); 1995 FSA Lexis 268 (Nov. 27, 1995) (when an employee receives a tax equalization payment from the employer subject to a contractual obligation to repay to the employer if the taxpayer gets a refund, *held*, section 1341 is available for the repayment under *Van Cleave*).

[45]*Dominion Resources Inc. v. United States*, 219 F.3d 359, 363-368, (4th Cir. 2000), *Doc 2000-20314, 2000 TNT 148-5* (a right to income does not fail to be apparent merely because it also happens to be actual). *See also MidAmerican Energy Co. v. Commissioner*, 271 F.3d 740, 744 (8th Cir. 2001), *Doc 2001-28694, 2001 TNT 222-7* (similar, in dictum); *WICOR Inc. v. United States*, 263 F.3d 659, 663 (7th Cir. 2001), *Doc 2001-21756, 2001 TNT 159-5* (similar, in dictum).

is section 1342(a)(2).[46] Some early case law also analyzed those repayments as voluntary, thereby barring section 1341 treatment by application of section 1342(a)(2).[47] However, the concept of involuntariness as a touchstone for section 1341 has led to a practical and conceptual dead end. It is unclear, for example, whether the definition of ''voluntary'' for section 1341 purposes is the same as that used for section 162 and section 165(c)(1) purposes. Early cases used the term as interchangeable and identical for all three sections.[48] By contrast, other cases have held that payments deductible under section 162 or 165(c)(1) may nonetheless be too ''voluntary'' to warrant section 1341 treatment. A rich source of that confusion — with differing outcomes among cases with seemingly similar facts — are the many cases involving settlements in anticipation of litigation.[49]

In any event, recent IRS authorities appear to avoid use of the voluntary-versus-involuntary distinction in section 1341 analysis, possibly because of the concept's lack of utility. And the case law has apparently abandoned the concept entirely in favor of the more fruitful ''same-circumstances'' test, as discussed immediately below.

6. Section 1341 and the courts: *Dominion Resources* and the same-circumstances test. In *Dominion Resources*, the Fourth Circuit expressly rejected the IRS's facts-in-existence test. The court disagreed with the IRS's premise that the right to receive income is not ''apparent,'' as required by section 1341(a), if the right also happens to be ''actual,'' sensibly observing that an apparent right can include ''an appearance that happens to be true.''[50] Under *Dominion Resources*, the touchstone for section 1341 is the same-circumstances test. Under that test, a payment is eligible for section 1341 only if it is a repayment arising from ''the circumstances, terms, and conditions of the original payment of such item to the taxpayer.''[51]

a. *Dominion Resources* explained. *Dominion Resources* involved a regulated utility whose rates included a charge to prepay anticipated federal income taxes. Tax legislation enacted in 1986 lowered the corporate income tax rate from 46 to 35 percent. As a result, after 1986 the tax prepayments already collected from customers exceeded the utility's now-expected federal tax obligations by $10 million. As required by its regulators, the utility rebated the excess $10 million to its customers in 1991, and it claimed a section 162 deduction and section 1341 credit for the rebate.[52] The IRS maintained that section 1341 was unavailable, reasoning that, under the facts in existence during the years the $10 million prepayment was collected, the utility had an actual rather than apparent right to the amount as required under both section 1341(a)(1) and (a)(2). The Fourth Circuit rejected the IRS's distinction between an actual and apparent right

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[46] Section 1342(a)(2) requires that it be determined after the close of the tax year that the taxpayer did not have an unrestricted right to the payment. *See, e.g.*, TAM 9516002; ILM 200808019 (Nov. 13, 2007), *Doc 2008-3742*; *2008 TNT 37-13*; 2001 IRS CCA Lexis 304; Rev. Rul. 58-456, 1958-2 C.B. 415.

[47] *Blanton v. Commissioner*, 46 T.C. 527 (1966) (when officer-shareholder repays salary determined by the IRS to be nondeductible, under an agreement with the employer entered into after salary paid, *held*, voluntary repayments are not deductible under section 162(a) or section 1341, because the repayment fails section 1342(a)(2)); *Pahl v. Commissioner*, 67 T.C. 286 (1976) (similar to *Blanton*); *Berger v. Commissioner*, 37 T.C. 1026 (1962) (when is salary repaid to an employer under an agreement, entered into after the salary is paid, that amounts are to repaid if determined by the IRS to be nondeductible, *held*, deduction is not available under section 1341(a)(2) when the repayment is voluntary. For the repayment to be other than voluntary, the payee must have at least the ''ability to legally compel'' the repayments); *Barrett v. Commissioner*, 96 T.C. 713 (section 1341 is not available unless the taxpayer is under a legal obligation to repay); *Kappel v. United States*, 437 F.2d 1222 (3d Cir. 1971) (similar); *Adams*, 58 T.C. 41 (final judgment not required, but section 1341 is available only if repayment arises from a determination that the claim against the taxpayer would be resolved adversely to the taxpayer); *Pike v. Commissioner*, 44 T.C. 787 (1965), *acq*. 1968-2 C.B. 2.

[48] *Blanton*, 46 T.C. 527 (voluntary repayments nondeductible under sections 162 and 1341); *Pahl*, 67 T.C. 286 (voluntary repayments nondeductible under sections 162, 165, and 1341); *But see Pike*, 44 T.C. 787, *acq*. 1968-2 C.B. 2 (when profits are repaid in response to an administrative investigation, *held*, the repayment is not eligible for section 1341, because the taxpayer could not prove the validity of the claims against him, even though the repayment is deductible as an ordinary and necessary business expense under section 162).

[49] *Compare Pike*, 44 T.C. 787; *Adams*, 58 T.C. 41; *with, e.g.*, ILM 200808019 (in case involving disgorgement of insider trading profits under section 16(b), section 1342(a)(2) does not require that repayment obligation be established by final judgment); Rev. Rul. 58-456, 1958-2 C.B. 415 (section 1342(a)(2) does not require that repayment obligation be established by final judgment); 2001 IRS CCA Lexis 304 (when officers return stock bonuses in settlement of civil suit, and settlement agreement specifies that they ''believe they would prevail,'' *held*, repayment not ''voluntary,'' because officers presumptively would

(Footnote continued in next column.)

not return bonuses absent litigation); *Barrett*, 96 T.C. 713 (section 1341 applies only to compensation repaid under a legal obligation to repay, but the requirement is met for amounts returned under a settlement agreement).

[50] *Dominion Resources*, 219 F.3d at 363-368.

[51] *Id.* at 367, quoting *Pahl*, 67 T.C. at 290, and *Blanton*, 46 T.C. at 530.

[52] Numerous regulated utilities claimed section 1341 treatment for tax-related rebates after the 1986 legislation, triggering IRS opposition and a rich load of case law. The utilities took advantage of the fact that section 1341 is especially beneficial when income tax rates go down. The second benchmark computation — recalculating the prior year's tax without the disputed payment — is computed under the old, higher tax rate, yielding a credit that is more valuable than a deduction for the same amount at the current, lower tax rate.

under both subsections. The court held that section 1341 treatment was available because customers' original payment of the $10 million and the utility's required repayment both arose from the same obligation, namely the utility's "liability to the federal government for deferred income taxes."[53] The $10 million was originally collected to prepay federal income taxes at an anticipated 46 percent rate; repayment was required because the anticipated 46 percent rate did not materialize. Accordingly, the rebate arose from the same "circumstances, terms, and conditions" as the initial payment, and section 1341 applied.[54]

In short, under *Dominion Resources*, section 1341 does not depend on whether the repayment obligation is imposed retroactively to a payment already made. Rather, what matters is that the original payment was paid because of specified assumptions, or based on expected conditions, and repayment is triggered because those assumptions or conditions are not satisfied.

b. Other courts follow *Dominion Resources* approach. Other courts have similarly rejected the IRS's distinction between apparent and actual rights to income for section 1341 purposes, in favor of the same-circumstances test.[55] The precise contours of the test remain somewhat vague. But in all cases, the underlying idea is that the repayment must involve restoration of the "same" item paid in an earlier year,[56] or, in another formulation, that conditions underlying the original payment be the but-for cause of the repayment.[57] For example, under the same-circumstances test, it has been held that section 1341 did not apply to a utility's payment of environmental remediation costs, even though the costs related to earlier income-generating business activity, because the liability was measured by the cost of remediation rather than the earlier-received income and arose from retroactively effective environmental laws unrelated to the conditions for receiving the originally received income.[58] Similarly, when a corporate officer paid a Federal Trade Commission (FTC) penalty, it was held that the penalty payment could not be treated under section 1341 as repayment of salary received in an earlier year, because the penalty arose from the taxpayer's violation of a consent order rather than from the "circumstances, terms, and conditions" of his original receipt of salary and the penalty amount was not computed with reference to the earlier-paid salary.[59] And when an executor reimbursed an estate's late filing penalty, section 1341 treatment was unavailable for the penalty reimbursement on the grounds that the penalty reimbursement was not repayment of previously received commissions and that it would have been required even if no commissions had

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[53]*Dominion Resources*, 219 F.3d at 368 (section 1341 is satisfied because (i) the utility's original collection of rate payments and its required restoration of those payments both arose from the same obligation, namely the utility's "liability to the federal government for deferred income taxes," and (ii) even though the utility did not repay the identical customers who paid the original charge, it came reasonably close).

[54]One possibly confounding point is worth clearing up. *Dominion Resources* may appear to throw some confusion on our issue because in articulating the same-circumstances test the court cited *Pahl* and *Blanton*. 219 F.3d at 367, citing *Pahl*, 67 T.C. at 290 (quoting *Blanton*, 46 T.C. at 530); *Pahl* and *Blanton*, two unreasonable-compensation cases, denied a deduction under sections 162, 165, and 1341 when the original payment was made before the repayment agreement was in effect. Because section 1341 is available only for repayments already deductible under another code section, the section 1341 portion of the opinion in both cases is only dictum. In any event, *Dominion Resources* greatly expands the scope of their same-circumstances test as first set forth in *Pahl* and *Blanton*.

[55]*MidAmerican Energy*, 271 F.3d at 744 (in dictum, the court declines to comment on the IRS's argument that an "actual" right to income is not an "apparent" right to income for section 1341(a) purposes, "but, as the Seventh Circuit did in *WICOR*, we note that all the appellate courts that have addressed it have rejected the commissioner's argument."); *WICOR*, 263 F.3d at 663 (in dictum, court declines to comment on the IRS's argument that an "actual" right to income is not an "apparent" right to income for section 1341(a) purposes, but "will merely note for completeness that the only appellate cases to address the issue have sided with the taxpayer" (citing *Dominion Resources*, *Van Cleave*, and *Prince*)).

[56]*Reynolds Metals Co. v. United States*, 398 F. Supp.2d 692, 702 (E.D. Va. 2005), *Doc 2005-18068, 2005 TNT 169-6* (payment must be "repayment or restoration of an item of gross income included in prior years.").

[57]1997 FSA Lexis 147 (June 17, 1997) (same-circumstances test is "not met if the payment obligation would arise even if compensation not received.").

[58]*Reynolds Metals*, 398 F. Supp.2d 692 (section 1341 does not apply to environmental remediation costs, even though costs arise from earlier years business activities, because (i) liability amount is computed on "cost of remediation" rather than income; (ii) current remediation costs are result of the enactment of retroactive environmental laws, rather than the "same circumstances or conditions of the original payment" and are thus not "repayment or restoration" of original payment; and (iii) costs are not being paid to original payers).

[59]*Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985) (when taxpayer received compensation as corporate officer and later paid a civil penalty for violating an FTC order, *held*, same-circumstances test is not met because penalty "arose from the fact that Bailey violated the consent order, and not from the 'circumstances, terms, and conditions' of his original receipt of salary and dividend payments," and because "the amount of the penalty was not computed with reference to the amount of his salary, dividends, and bonuses, and bears no relationship to those amounts.").

been received.[60] Similar reasoning applied to a taxpayer's restitution payments for fraud.[61]

c. Clawbacks under *Dominion Resources*. As set forth in *Dominion Resources* and the foregoing cases, the same-circumstances test means that section 1341 should apply to any clawback if the reason for the clawback is that the conditions on which the compensation was originally paid later turn out to be unsatisfied. The logic of *Dominion Resources* covers clawbacks that might otherwise be problematic under the facts-in-existence test, including retroactive clawbacks and bad boy clawbacks.

Assume, for example, that a performance bonus, contingent on stated earnings and profits benchmarks, is awarded in 2009. Assume that after 2009 the employer adopts a clawback policy for performance bonuses paid for any year for which earnings are restated, effective retroactively, and assume that the 2009 bonus is accordingly clawed back. Since the 2009 bonus was received contingent on specific conditions (earnings), and repayment is required because those anticipated conditions were not satisfied (earnings restated), *Dominion Resources* should apply section 1341 treatment to the clawback. If, however, the bonus were based on performance metrics unrelated to those triggering the clawbacks, the answer might be different. Dodd-Frank clawbacks would appear to satisfy *Dominion Resources.* The statute requires that the clawbacks apply only to the portion of incentive pay that would not have been paid absent the material misstatement corrected by the restated financials. Those ''but for'' clawbacks seem to be covered by the *Dominion Resources* theory.

Similarly, *Dominion Resources* should generally cover clawbacks for breach and detrimental activity. Return to the example of the executive whose severance pay is awarded contingent on his honoring a covenant not to compete, and who breaches the noncompete agreement. Like the tax prepayment made to the *Dominion Resources* utility, the severance bonus was paid in anticipation of specified future events (adherence to agreements), and the repayment was required because the anticipated event did not materialize (breach).

[60]*Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977) (section 1341 not available for executors' reimbursement of estate's late filing penalty because reimbursement is not repayment of commissions previously included in income, repayment would have been required even if no commissions received).

[61]*Kraft v. United States*, 991 F.2d 292, 295 (6th Cir. 1993), *Doc 93-4425, 93 TNT 79-15* (section 1341 not available for restitution payment for fraud to Blue Cross, because item included in income (medical fees from Blue Cross) ''did not arise out of the same circumstances, terms and conditions'' as restitution payment).

7. Tax consequences for the employer. If compensation repaid by an employee under a clawback was deducted by the employer when first paid and the repayment is included in the employee's income under Rev. Rul. 79-311 (whether or not the employee also claims a deduction), the tax benefit rule requires that the employer take into income the amount it deducted when the bonuses were first paid.[62]

II. Retroactive Clawbacks: Special Issues

Some employers may apply their clawback policy retroactively to cover compensation first paid before the policy was adopted. The question arises as to whether repayments under a retroactively imposed policy (retroactive clawbacks) are deductible under either section 162(a) or section 165(c)(1) and whether they are eligible for section 1341.

A. Are Repayments Deductible?

No deduction may be claimed under section 162(a) or 165(c)(1) for a repayment that is voluntary. The definition of ''voluntary'' for this purpose is not entirely clear. As a result, there is some question as to whether retroactive clawbacks — repayments of amounts first paid before the clawback policy was adopted — are deductible.

1. Retroactivity and the unreasonable compensation cases. The first question is whether a repayment is voluntary if it was made under a repayment policy adopted after the payment was first made. The doubt surrounding retroactive repayment policies arises from the long line of ''unreasonable compensation'' authorities. They involve compensation repaid by an officer-shareholder to the employer-corporation under an agreement stating that compensation would be repaid if the IRS later determined that the compensation was nondeductible because excessive or unreasonable under section 162.[63] In all those instances, it was held that a deduction was available under section 162 for compensation first paid *after* the repayment agreement was in effect.[64] But a section 162 deduction was not

[62]IRS CCA Lexis 302 (June 15, 2001).

[63]Reg. section 1.162-7(a) (ordinary and necessary trade or business expenses include a ''reasonable allowance for salaries or other compensation for personal services actually rendered'').

[64]*Oswald v. Commissioner*, 49 T.C. 645 (1968) (repayment of part of an officer-shareholder's salary for 1960 was held deductible under section 162(a), where repayment was required by the corporation's 1952 bylaw requiring repayment of salary disallowed as a deduction); *Pahl*, 67 T.C. 286 (1976) (when officer-shareholder repays portions of salary earned over two years under agreement to repay amounts determined by the IRS to be nondeductible; *held*, amounts *paid* after agreement entered into (even though earned before that date) are deductible under

(Footnote continued on next page.)

available for repayment of amounts first paid *before* the repayment agreement was in effect, on the grounds that those repayments were voluntary.[65] The same constraint applies to business losses claimed under section 165(c)(1).[66]

Oddly, the concern for retroactivity arises on a when-paid basis, rather than a when-earned basis. Repayments of unreasonable compensation are apparently deductible if *paid* after the repayment requirement goes into effect, even if *earned* by services performed before the requirement went into effect.[67]

2. Unreasonable-compensation cases are distinguishable. Do the unreasonable-compensation cases mean that the class of nondeductible ''voluntary'' repayments includes all repayments made under a retroactive repayment policy, such as the retroactive clawbacks discussed here? The likely answer is no; these cases are inapplicable to retroactive clawbacks. The unreasonable-compensation cases all involve agreements entered into between a corporation and its officer-shareholder under which the officer-shareholder agreed to return salary paid in a year to the extent the salary was determined by the IRS to be nondeductible under section 162. In *all* of those cases, the officers were also shareholders, so the repayments were in substance a repayment of dividends amounting to a nondeductible contribution to capital. The repaying officers did not forfeit the repaid amounts. Rather, by repaying purported compensation to a corporation in which they were shareholders, they merely restructured their investment returns by repaying dividends as a contribution to capital.[68] By contrast, clawback policies are instituted unilaterally by the employer. The clawback is an unambiguous forfeiture, not a recharacterization of investment returns.

3. Not 'voluntary' if precondition for other compensation. A different definition of voluntary has been advanced: Repayments are not voluntary if required to receive other pay or benefits. This definition supports the deductibility of retroactive clawbacks, at least when repayment is the condition of receiving, say, future bonuses, a pay raise, or even continued employment. The IRS has long recognized that those repayments are not voluntary for section 165(c)(1) purposes. For example, Rev. Rul. 82-178 dealt with laid-off employees who, on rehire, were entitled to be restored service credits and other employment rights, contingent on their repaying formerly received lump sum severance payments within 60 days of rehire. The ruling held that, even though not mandatory, repayment of the severance was deductible under section 165(c)(1) as a loss incurred in the employee's trade or business because it was required as a condition of restoring other benefits.[69] Rev. Rul. 79-322 involved a federal employee whose repayment of sick pay received in an earlier year was a condition for receiving worker's-compensation-type benefits. It was held that amounts paid to repurchase sick leave pay were a business loss deduction under section 165(c)(1).[70]

These rulings support the position that retroactive clawbacks are deductible under section 165(c)(1), at least if the repayment is a condition for future pay. While strong authority, the rulings are unfortunately not bulletproof. One confounding factor is that the repayment policy in the rulings

section 162(a)); Rev. Rul. 79-311 (when amounts advanced in an earlier year are repaid in later year to the extent they exceed commissions earned under an agreement in effect at time of original advance, *held*, repayments are deductible under section 162(a)); Rev. Rul. 69-115, 1969-1 C.B. 50 (when amounts paid in an earlier year are repaid by an employee in a later year under an agreement in effect at the time of the original payment to repay amounts determined by the IRS to be nondeductible, *held*, the repaid amounts are deductible under section 162(a), even though the subsequent events test barred section 1341 treatment (under section 1341(a) ''appeared'' test)); 2001 IRS CCA Lexis 302 (June 15, 2001) (when bonuses paid in an earlier year were repaid under a settlement of civil litigation, *held*, repayment was deductible by taxpayers under section 162(a)).

[65]*Blanton*, 46 T.C. 527 (when officer-shareholder returns amounts pursuant to agreement to repay amounts determined to be nondeductible, and agreement entered into after year in which amounts first paid, *held,* no deduction under section 162 or section 1341). *Pahl*, 67 T.C. 286 (when officer-shareholder returns amounts under an agreement to repay amounts determined to be nondeductible, *held*, amounts *paid* before agreement entered into are not deductible under sections 162 and 165 (or section 1341); but (ii) amounts *paid* after agreement entered into (even though earned before that date) are deductible under section 162(a)); *Simon v. Commissioner*, 281 F.2d 520 (6th Cir. 1960) (when lessees rebate rental payments to the corporate lessor of which lessees are the sole shareholders, under an agreement entered into after the rental income was initially paid, *held*, no deduction is available either as a loss, or as an expense of carrying on a trade or business, under the 1939 Internal Revenue Code).

[66]*Simon*, 281 F.2d 520; *Pahl*, 67 T.C. 286.

[67]*Pahl*, 67 T.C. 286.

[68]*See, e.g.*, *Berger*, 37 T.C. 1026, for an opinion expressly analyzing a restoration of ''unreasonable compensation'' as just such a repayment of (nondeductible) dividends to the distributing corporation in the form of the shareholder-employee's (nondeductible) contribution to capital. *See also Simon*, 281 F.2d 520, for an identical analysis in the case of purported overpayments of rent repaid by lessee-shareholders to the corporate lessor of which they were the sole shareholders. The *Simon* court analyzed the purportedly restored rent as a repayment of (nondeductible) dividends in the form of a (nondeductible) contribution to capital from the lessee-shareholders to their wholly owned lessor corporation.

[69]Rev. Rul. 82-178, 1982-2 C.B. 59.

[70]Rev. Rul. 79-322, 1979-2 C.B. 76.

was apparently in place when the original compensation was received. This apparent fact, however, forms no part of the IRS's reasoning in concluding that repayment was not voluntary.[71]

4. Bottom line: Retroactive clawbacks are likely deductible. In short, while the matter is not free from doubt, the likely answer is that retroactive clawbacks are deductible by the employee. To better ensure the deductibility of retroactive clawbacks, the employer may prefer to design the clawback policy to state that nonpayment of clawback may be penalized by nonpayment of compensation later payable (such as future performance bonuses).

B. Is Section 1341 Available?

Part I discussed the issues raised by applying section 1341 to retroactive clawbacks. We here briefly recapitulate that discussion. The IRS's current touchstone for section 1341 still seems to be the confused and confusing facts-in-existence test. Under this test, section 1341 might not apply to a retroactive clawback. This is because the facts in existence when the original payment was made did not include the repayment contingency. By contrast, the approach adopted by the courts — the *Dominion Resources* or same-circumstances test — would apparently allow section 1341 for retroactive clawbacks, at least those clawbacks triggered because the original payment was predicated on conditions or assumptions that turned out not to be the case. For example, if a bonus is granted for reaching stated earnings targets and the bonus is clawed back because earnings for that year are restated, *Dominion Resources* should permit the application of section 1341, even if the clawback policy was put in place only after the bonus was originally paid.

III. Bad Boy Clawbacks: Special Issues

It is not unusual for compensation agreements to condition payment on good behavior and to provide for a clawback in the event of breach. Examples are severance bonuses conditioned on a covenant not to compete, a covenant of confidentiality, or, more broadly, a covenant to refrain from activity detrimental to the employer. If the executive fails to observe these covenants, the bonus may be clawed back under the agreement.

A. General Tax Treatment

Generally, a payment made by an employee or former employee as liquidated damages for breach of an employment contract is deductible under section 165(c)(1).[72] Section 1341 raises more complicated issues, which were set forth at length in Part I and are briefly summarized here. The IRS has long taken the position that repayments for breach of an employment agreement are not eligible for section 1341. The IRS initially reasoned that section 1341 does not apply if the employee had an unrestricted right to receive compensation and the repayment arose from a "subsequent event."[73] The IRS abandoned its subsequent-event test after *Van Cleave.* But its apparent current contender for section 1341 analysis, the facts-in-existence test, seems similarly unlikely to allow section 1341 treatment for clawbacks arising from a breach of contract. Even under the new test, a later arising breach would presumably not be considered a fact in existence at the time of the original payment, and section 1341 would presumably not apply.

Here, as with retroactive clawbacks, the same-circumstances theory of *Dominion Resources* and other case law would appear to allow section 1341 treatment. Return to the hypothetical executive whose severance bonus is expressly conditioned on his agreement not to compete, to solicit, or otherwise engage in detrimental activity. Since the payment is conditioned on specific promises and the clawback arises because the promises are not kept, section 1341 would apply.

B. Section 1341 and the Claim-of-Wrong Rule

For some clawbacks, one additional doctrine may preclude section 1341 treatment. The IRS and the courts agree that, by statute, section 1341 is not available when payment was received without any "appearance" of unrestricted right. Thus, for example, if an individual who embezzled funds is later required to repay them, section 1341 is unavailable for the repayment.[74] While no authority exists on this point, it is conceivable that this "claim

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[71]Additional confusion arises from the fact that the two involuntary-repayment rulings are conceptually indistinguishable from the no-personal-liability rulings discussed above, in which overpayments could be recouped only by setoff against later-paid amounts. In both categories of rulings, repayment is in effect accomplished only if the economic value of later-paid compensation is computed net of the repaid compensation. Yet, for the no-personal-liability rulings, the repayment may be netted for tax purposes against the compensation against which the holdback is made. By contrast, under the involuntary-repayment rulings, the repayment is deductible under section 165(c)(1). This residual confusion is an irreducible part of the analytic untidiness surrounding the tax treatment of repayments.

[72]*See, e.g.*, Rev. Rul. 67-48 (amount of liquidated damages paid by the taxpayer to his employer for breach of an employment contract was attributable to compensation received for services, and deductible under section 165(c)(1)); GCM 39336 (Feb. 5, 1985).

[73]Rev. Rul. 67-48, 1967-1 C.B. 50; Rev. Rul. 58-226, 1958-1 C.B. 318.

[74]Rev. Rul. 68-153, 1968-1 C.B. 371 (holding proceeds from embezzlement activity later repaid, the embezzler was not

(Footnote continued on next page.)

of wrong'' doctrine could deny section 1341 treatment to a clawback enforced in egregious situations. Consider, for example, the executive who knowingly participates in the creation of false financial statements that support a performance bonus based on phantom earnings, and whose bonus is clawed back when those phantom earnings are restated. Could the claim-of-wrong doctrine preclude section 1341 in that case? The answer is unclear and will depend on the facts. The threshold for wrongdoing is high and does not appear to apply short of conviction for or admission of criminal wrongdoing.[75] Accordingly, section 1341 is probably not deniable merely because the clawback is triggered by, say, violation of a covenant not to compete or an earnings restatement if criminal wrongdoing is not implicated.

IV. 409A, Other Former Employee Issues

A different set of issues is raised by clawbacks from former employees. The threshold question is whether a terminated employee, especially one who is retired altogether from the labor force, can claim a trade-or-business deduction for amounts paid to his former employer. As is shown below, the nonobvious but apparently correct answer is yes. The next issue is whether section 1341 is available. Here the answer also is shown to be yes. Finally, Part IV considers whether clawbacks enforced through holdbacks from deferred compensation might violate section 409A, and it explains how to avoid a section 409A violation.

A. Itemized Deductions and Former Employees

The first issue is whether a former employee can claim a deduction for repayments of compensation paid by a former employer. Whether claimed under section 162 or 165(c)(1), a deduction is available only if the repayment relates to the taxpayer's trade or business of being an employee. The question is thus whether a former employee can still be in the trade or business of being an employee — especially when retired altogether.

The answer appears to be yes. As a general matter, it is well established that former employees can deduct expenses related to their former employment. For example, terminated employees can deduct the legal expenses related to their wrongful termination suits.[76] Former employees can claim a section 162 deduction for outplacement services to the same extent, and under the same limitations, that they could claim a section 162 deduction if still employed.[77]

By themselves, the wrongful termination cases and the outplacement service cases are not entirely comforting. In both kinds of cases, the former employee has retained an attachment to the workplace and to his line of work. The wrongfully terminated employee in effect claims he should still be working; the individual seeking outplacement services is, by definition, staking out an attachment to expected future employment. They do not by themselves answer the question whether a former employee can ever be so totally severed from the labor force that the section 162 or 165(c)(1) deduction is unavailable.

Under IRS guidance, the answer seems to be that even a completely retired employee can deduct repayments of compensation under section 165(c)(1). For example, the IRS has ruled that when a retiree is required to repay inadvertent overpayments received in a previous year from a qualified defined benefit plan, the repayments are deductible under section 165(c)(1).[78] Similarly, a former employee who was required to pay liquidated damages for breach of contract was allowed to deduct

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permitted a refund calculated under section 1341). *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978); *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989).

[75] *Compare Barrett*, 96 T.C. 713 (when amounts were returned under a settlement of criminal charges and the taxpayer did not concede criminal wrongdoing, *held,* section 1341(a)(1) does not bar the availability of section 1341), *nonacq*. AOD CC 1992-008 (Mar. 23, 1992) *with Parks v. United States*, 96-2 USTC (CCH) (W.D. Penn. 1996) (disagrees with *Barrett*); *see* ILM 200808019 (claim of wrong does not bar section 1341 when section 16(b) requires disgorgement of profits, since disgorgement is an absolute obligation, without regard to wrongdoing).

[76] *Biehl v. Commissioner*, 118 T.C. 467, 477-478 (2002), *Doc 2002-13103*, *2002 TNT 105-4* (attorney fees paid by a former employee in a wrongful termination suit are deductible below the line under section 162, because they are incurred in his trade or business of being an employee), *aff'd*, 351 F.3d 982 (9th Cir. 2003), *Doc 2003-26408*, *2003 TNT 240-47* (citing *McKay v. Commissioner*, 102 T.C. 465, 489 (1994), *Doc 94-3399, 94 TNT 60-9* (former employee's legal expenses incurred in wrongful discharge suit are deductible under section 162 as ordinary and necessary expense incurred in his trade or business of being an employee, even if suit carried on against former employer, *vacated and remanded on another issue*, 84 F.3d 433 (5th Cir. 1996), *Doc 96-13888, 96 TNT 92-7*)); *Alexander v. Commissioner*, T.C. Memo. 1995-51, *Doc 95-1555, 95 TNT 21-18* (held: taxpayer's legal fees paid in connection with settlement of suit filed against former employer for breach of employment contract deductible under section 162), *aff'd*, 72 F.3d 938 (1st Cir. 1995), *Doc 96-602, 96 TNT 1-74*.

[77] Rev. Rul. 92-69, 1992-2 C.B. 51 (holding that the threshold condition of seeking section 132 exclusion for outplacement services is the ability to claim a deduction for the expense as an ordinary and necessary expense in the trade or business of being an employee under section 162, and that this threshold condition is met by former employees to the same extent as if they were current employees. In both cases, the deduction is available only for expenses relating to seeking employment in the same line of work).

[78] Rev. Rul. 2002-84, *supra* note 13, Situation 3.

the repayments under section 165(c)(1).[79] In neither ruling is it stated that the former employee has potentially continued employment in his former line of work. In short, it appears that a former employee — even a former employee whose connection to the labor force has terminated entirely — can deduct clawbacks of compensation paid from the former employer under section 165(c)(1).

B. Section 1341 and Former Employees

Section 1341 is available to a former employee to the same extent as to a current employee. For example, when a retired employee repays inadvertent overpayments from a qualified plan received in a previous year and deducts the repayment under section 165(a)(1), the IRS has ruled that the retiree can in addition claim section 1341 treatment if the repayment exceeds $3,000.[80]

C. Section 409A and Setoffs

For a terminated employee, the employer may want to enforce a clawback by holding back amounts from severance or other post-termination pay. In many cases, the post-termination pay will be nonqualified deferred compensation subject to section 409A. Holding back amounts from nonqualified deferred compensation implicates the ''substitution'' rule of regulations under section 409A. As with all things section 409A, the resulting issue is complex — although here (unlike many section 409A issues) apparently resolvable.

1. Problem: The substitution rule. The substitution rule of the section 409A regulations says that any payment made as a substitution for a payment of deferred compensation is deemed to be payment of that deferred compensation.[81] The substitution thus violates section 409A if paid impermissibly earlier than scheduled for the deferred compensation (in violation of the prohibition on accelerations) or impermissibly later (in violation of the rule against nonconforming redeferral elections). Holding back repayments from nonqualified deferred compensation can be a prohibited substitution in two different ways.

First, the regulation says that if payment of an amount results in an actual or potential reduction or current or future offset to an amount of deferred compensation, the payment is a substitute for the deferred compensation. The regulation further explains that if the service provider receives a loan, the repayment of which is secured by or may be accomplished through offset or reduction of deferred compensation, then the loan is a substitute. The breathtaking sweep of these rules raises problems. Assume, for example, that a bonus is paid subject to a clawback policy, and further assume that the policy expressly provides for enforcement via holdback from any later-paid compensation without limitation, including nonqualified deferred compensation. Payment of the bonus is accordingly a potential reduction of deferred compensation. Moreover, if the clawback is triggered, the obligation (arguably) gives rise to a loan, the repayment of which is secured by offset or reduction of deferred compensation.

The second potential violation of the substitution rule arises from the puzzling purported exception for offsets to repay employer-provided loans under reg. section 1.409A-3(j)(4)(xiii). It says that a plan may provide for the acceleration of payment, as ''satisfaction of a debt of the service provider to the service recipient,'' up to an amount of no more than $5,000 (for all years), if the reduction is made ''at the same time and in the same amount as the payment otherwise would have been due and collected from the service provider.'' This provision has raised concerns that a holdback in excess of $5,000 against deferred compensation to satisfy any repayment obligation by the employee to the employer might automatically violate section 409A.

In short, the substitution rule of the section 409A regulations raises the counterintuitive possibility that, if the employer's clawback policy contemplates enforcement by holding back amounts from nonqualified deferred compensation, either the originally paid compensation or the later holdback might violate section 409A.

2. Solution: Apply Rev. Rul. 79-311 to setoff. Despite the intricacies of the substitution rule, clawbacks enforced by being held back from nonqualified deferred compensation can apparently be structured not to violate section 409A.

To illustrate the solution, assume that an executive is paid a $100,000 performance bonus for 2010. In 2012 the executive is terminated and as a result is owed a $500,000 parachute. Assume that, because of an earnings restatement for 2010, the employer claws back the $100,000 bonus and enforces the clawback by setoff from the parachute payment, resulting in a net payment of $400,000 in 2012. Further assume that, in compliance with Rev. Rul. 79-311, the employer reports the gross $500,000 on the executive's Form W-2 for 2012 (even though the executive received a net payment of only $400,000).

What has happened here? Even though the $100,000 performance bonus is originally paid subject to a potential clawback, and even though the

[79] Rev. Rul. 67-48, 1967-1 C.B. 50 (when an amount is paid by a taxpayer as liquidated damages for breach of contract to a former employer, it is deductible as a business loss under section 165(c)(1) in the year paid).

[80] *Id.*

[81] Reg. section 1.409A-3(f).

clawback reduces the net amount received in 2012 by an identical $100,000, the performance bonus paid in 2010 is not a substitution for the $100,000 subtracted from the 2012 parachute. Why? For section 409A purposes, ''payment'' is defined as inclusion in income.[82] Accordingly, the setoff is not a ''reduction'' of the $500,000 parachute payment; rather, the $500,000 parachute is paid in full in 2012, because it is fully includable in gross income (even though the executive actually receives only $400,000). The $100,000 is included in gross income twice (once in 2010 and once in 2012); the earlier payment is not a ''substitute'' for the later one as that term is defined under section 409A.

Similarly the $100,000 holdback in 2012 is not a prohibited substitution for any portion of the 2010 parachute payment in violation of the $5,000 limit under reg. section 1.409A-3(j)(4)(xiii). Even assuming that the holdback is a substitution, it is not a *prohibited* substitution, because the timing of payment stays unchanged. Absent the setoff, the $100,000 is part of the executive's compensation in 2010. With the setoff, the $100,000 is still included in the executive's 2010 wages and gross income under Rev. Rul. 79-311. The deemed payment is paid at the same time the real payment would have been paid, and section 409A is satisfied.

3. Alternative approach: Excluding holdback from gross income. Assume that a clawback is enforced by being held back from payments of nonqualified compensation, and the employer reports the deferred compensation payments on the employee's forms W-2 or 1099 net of the held-back amounts (in violation of LTR 9103031 but in compliance with Rev. Rul. 2002-84). In the above example, the employee's parachute reported as included in gross income would be only $400,000 — the $500,000 parachute net of the $100,000 clawback.

Does this alternative tax treatment mean that the $100,000 bonus received in 2010 is a prohibited substitution for a portion of the parachute payable in 2012? Or that the $100,000 holdback is a violation of the $5,000 limit under reg. section 1.409A-3(j)(4)(xiii) for offsets to repay a debt to the service recipient? The sensible answer to both questions should be no. Even assuming that it was paid subject to the broadest possible clawback contingency, the 2010 bonus created a potential reduction of nonqualified deferred compensation only in the most remote and indirect sense. And it was certainly not paid as a debt, but rather as a taxable amount received under a claim of right. Nonetheless, under the excessively broad reach of the substitution rule of the section 409A regulations, the sensible answer cannot be assumed to be the correct one.

Accordingly, to minimize the employee's risk under section 409A, clawbacks enforced by offset from nonqualified deferred compensation should be included in the gross amount of nonqualified deferred compensation reported on the employee's forms W-2 or 1099.

V. Repaying Employer Stock — Special Issues

The employer's clawback policy may require repayment of earlier payments of employer stock or stock options. Compensatory grants of property are taxed under section 83. Complications arise when the shares have risen or fallen in value between income inclusion and clawback.

To consider first the effects of appreciation, assume that the stock is transferred when its fair market value is $90, the substantial risk of forfeiture lapses when FMV is $100, and the clawback is imposed when FMV is $110. Assume that the employee pays nothing for the shares and does not make a section 83(b) election. Under regulations, if the shares are forfeited under a lapse restriction after substantial vesting (as in this example), the employee is allowed an ordinary loss deduction equal to basis in the property, which in our example is the FMV of the shares at the time of vesting.[83] The employee gets an ordinary loss deduction of $100 and section 1341 treatment (if otherwise available). Both the deduction and exclusion prongs under section 1341 are computed using the shares' FMV included in income ($100) rather than their appreciated value at the time of clawback ($110).[84]

Now assume that the shares are clawed back after declining in value to an FMV of $80. The employee is still allowed an ordinary loss deduction equal to basis,[85] in this case $100. Section 1341 treatment is more restricted. When computing the prior year's tax as if the shares had never been paid (under section 1341(a)(5)(B), what this article has termed the second benchmark computation), the taxpayer is permitted only to include the FMV of

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[82]72 *Fed. Reg.* 19,234, 19,235 (Apr. 17, 2007) (Preamble to the section). *See also* reg. section 1.409-1(b)4(i)(B) (definition of a ''payment'' for short-term deferral rule).

[83]Reg. section 1.83-1(c). Regulations define a lapse restriction as a restriction that is not a nonlapse restriction. Reg. section 1.83-3(i). The restriction is not a non-lapse restriction because it does not apply to subsequent holders of the property. Reg. section 1.83-3(h)(ii). Accordingly, the clawback is a lapse restriction.

[84]Reg. section 1.1341-1(d)(2)(i) (amount excluded from income for purposes of section 1341(a)(5)(B) computation shall not exceed amount included in income in prior year).

[85]Section 165(b)(1).

the shares restored ($80) rather than their FMV included in income at the time of vesting ($100).[86]

It has been assumed that the employee's shares vested before clawback. If the shares did not substantially vest, they were not included in income (absent a section 83(b) election), and no deduction is appropriate. If the taxpayer paid for the shares, the amount paid should be allowable as an ordinary loss deduction, even if they were not substantially vested.

Change the assumption so that the employee makes a section 83(b) election at the time of the grant, when the shares' FMV is $90. In that case, significantly harsher treatment applies to the clawback. Under section 83(b)(1) the taxpayer is not allowed a deduction for the forfeiture. If the taxpayer paid for the shares and the clawback occurs when the shares are still substantially nonvested, regulations give him a deduction for the amount paid.[87] The loss, however, may be taken only as a capital loss, rather than an ordinary loss.[88] If the property has substantially vested, the deduction for the payment amount is apparently unavailable.

VI. FICA Tax Consequences

For an ''overpayment'' that is later repaid, the employer and employee can recoup FICA taxes withheld and paid on the original payment if the refund is claimed no later than three years after the filing date of the return for the period in which the original payment was made. These provisions are governed by regulations under section 6413 relating to refunds of FICA tax erroneously collected from the employee and overpaid by the employer. IRS guidance clarifies that the overpayment refund provisions apply even if the erroneous overpayment relates to wages that were proper when made and only later returned because of subsequent events.[89]

In our example, the employer must reimburse the employee share of the FICA tax withheld from the original bonuses.[90] Reimbursement is effected by deducting the refunded FICA payments against the employee's share of FICA taxes otherwise withheld from wages paid in the repayment year, or it is made directly to the employee if the employee's FICA taxes in the repayment year are less than the refunded FICA taxes.[91] The employer reports the overpayment of both the employee's and employer's share of FICA taxes on an amended return (Form 941-X) for the period and generally receives an adjustment by taking a credit against the payment of employment tax liabilities for the return period in which the adjusted return is filed.[92] The employer must complete all these actions before the statute of limitations for filing a FICA refund claim has expired,[93] that is, not later than three years after the filing date of the original Form 941-X.[94] (By contrast, refunds of income tax withheld from wages may not be claimed after the calendar year in which the wages are paid.[95])

In our example, both the employee's and employer's share of FICA can be recouped on both the 2009 and 2010 bonuses. Change the example, however, so that the clawback also applies to the employee's 2008 bonus, paid in December 2008. By the date of the clawback in our example (July 2012), the statute of limitations for FICA refunds has run for the fourth quarter of 2008. Accordingly, for this hypothetical 2008 bonus, the FICA tax withheld on the clawed-back bonus cannot be cured if we assume that the payback amount is included in wages and taken only as a section 162 deduction.

A. Repay the Net or the Gross?

To get the employee's share of FICA refund under these provisions, the employee must actually repay the wages originally paid. It is not entirely clear whether the employee must repay the gross amount (that is, including the FICA taxes withheld) or repay only the amount net of FICA taxes withheld. Some IRS guidance suggests that repayment of the gross amount is required.[96] But in more recent

[86]Reg. section 1.1341-1(d)(2)(i) (exclusion allowed for ''amount restored in the taxable year'').

[87]Reg. section 1.83-2(a) (''If property for which a section 83(b) election is in effect is forfeited while substantially nonvested, such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of the amount paid for the property over the amount realized upon such forfeiture.''). *See, e.g.*, *Kadillak v. Commissioner*, 127 T.C. 184 (2006), *Doc 2006-22725*, *2006 TNT 216-10*, *aff'd*, 534 F.3d 1197 (9th Cir. 2008), *Doc 2008-16656*, *2008 TNT 147-7*; *Guzak v. United States*, 75 Fed. Cl. 304 (2007), *Doc 2007-5075*, *2007 TNT 40-11*.

[88]Reg. section 1.83-2(a) (''If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.'').

[89]*See, e.g.*, Rev. Rul. 79-311 (when advances paid to employees exceed earned commissioners and are repaid at termination of employment under a preexisting contact agreement, *held*, in relevant part, taxpayer can claim credit for employee's share of FICA taxes withheld, under reg. section 31.6413(a)-1(b)(i)).

[90]Reg. section 31.6413(a)-1(a)(2) (relating to return of overpaid employee's share of FICA, when error is ascertained after return is filed).

[91]Reg. section 31.6413(a)-1(b)(2)(iii).

[92]Reg. section 31.6413(a)-2(b)(i) and (ii) (employer adjustment for employees and employer's share of overpaid FICA tax when overpayment discovered after return is filed).

[93]*Id*.

[94]Reg. section 301.6511(a)-1(a)(1).

[95]Reg. section 31.6413(a)-1(b)(2)(i).

[96]SCA 1998029 (Dec. 4, 1988) (providing that ''*actual repayment* of wages by the employee to the employer through payroll deduction or otherwise must occur before an overpayment exists'' (emphasis supplied); further states that employer claims credits under reg. section 31.6413(a)-1(b)(1) and (a)-2 only ''after'' repayment).

guidance (dealing with returns of nonqualified deferred compensation erroneously paid in violation of section 409A), the IRS has implied that return of the net amount is sufficient if the employer has filed for refund under a properly filed Form 941-X.[97]

VII. Practical Conclusions

What can be concluded about clawbacks from the issues set forth in this article?

1. In the (probably rare) case of an amount repaid in the same year as first paid, the repayment is excluded from gross income. The employer reports wages and gross income on the employee's Form W-2 net of the repayment amount, regardless of whether the repayment is made directly (by writing a check) or held back from other compensation payable during the year.

2. More typically, clawbacks will require repayment of compensation first paid in a previous year. If the clawback affects compensation first paid *after* the clawback policy was adopted, tax treatment of the repayment is generally governed by Rev. Rul. 79-311. The repayment is not excluded or netted from the gross income and wages reported on the employee's Form W-2 for that year. To reverse in part the income taxes previously paid on the relinquished amount, the employee can deduct the clawback under section 162 (or 165(c)(1)), subject to the 2 percent floor and the AMT. The employee can also claim a credit or deduction under section 1341, thus reversing most or all of the income taxes previously paid. In any event, the employer takes the deduction back into income under the tax benefit rule.

3. If repayment of a previous year's payment is held back from other compensation rather than repaid directly, the authorities are somewhat mixed. The safer approach is to follow Rev. Rul. 79-311 and include holdbacks in the gross income and wages reported on the Form W-2 or 1099, subject to a deduction by the employee under section 162 or 165 (and section 1341 when available). Although this income inclusion is consistent with the approach for direct repayments, and supported by some IRS ruling authority, it is unclear that it is required. One major caveat applies: Following Rev. Rul. 79-311 for repayments held back from nonqualified deferred compensation avoids potential section 409A pitfalls.

4. Retroactive clawbacks — repayments of amounts first paid before the clawback policy was adopted — are more problematic. While the matter is not doubt free, retroactive clawbacks should be deductible under section 162 or 165(c)(1). To better ensure their deductibility, the employer may wish to include in the clawback policy a statement that the employee's nonpayment of the clawback will be penalized by reduction or elimination of future bonuses or other special pay. Availability of section 1341 is also likely but not certain. The IRS's position, while evolving, does not yet clearly support section 1341 treatment for retroactive clawbacks. By contrast, the case law supports section 1341 treatment when the same-circumstances test of *Dominion Resources* is satisfied — that is, when the payment is clawed back because the assumptions or conditions for which it was paid fail to obtain. For example, if performance bonuses are paid because stated earnings targets are achieved but they are later clawed back because earnings for that year are restated, section 1341 should apply (assuming the clawbacks are deductible).

5. Bad boy clawbacks — clawbacks triggered by the employee's breach of a covenant not to compete, another contract term, or by other detrimental activity — are deductible under section 165(c)(1). But, as with retroactive clawbacks, the application of section 1341 is less certain. Under the IRS's former subsequent-events test and its (apparently) current facts-in-existence test, section 1341 is unavailable if repayment is required by a breach arising after the original payment. By contrast, the same-circumstances test of *Dominion Resources* and other case law should allow section 1341 treatment in this case. If the circumstances of the clawback are so egregious as to implicate criminal conduct, the claim-of-wrong doctrine might preclude the application of section 1341.

6. Clawbacks repaid by former employees should be deductible under section 165(c)(1), even though the former employee has retired not only from the services of the employer but

[97]Notice 2008-113, 2008-2 C.B. 1305, section III.K, *Doc 2008-25693*, *2008 TNT 236-10*, generally requires that specified payments in violation of section 409A can be corrected only if the service provider repays the gross amount of the repayment to the service recipient before application of withholding taxes. But Notice 2010-6, 2010-3 IRB 275, section XII.A, *Doc 2010-190*, *2010 TNT 3-6*, clarifies that the requirement is satisfied if the service recipient repays only amount *net* of any withholding taxes "to the extent the service recipient has made a tax correction (*e.g.*, an adjustment made on Form 941-X, 'Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund') to recover the amount of taxes withheld on the amount erroneously paid."

from the labor force altogether. Former employees can also claim section 1341 treatment to the same extent that current employees can.

7. Clawbacks enforced by being held back from nonqualified deferred compensation raise special problems. Regulations under section 409A provide that those setoffs might cause either the original payment or the setoff to be a prohibited substitution, giving rise to taxation and penalties under section 409A. These section 409A obstacles may apparently be avoided by observing the IRS's prescribed tax treatment of setoffs under Rev. Rul. 79-311. That is, the employer should include the setoff in the gross nonqualified deferred compensation reported on the employee's Form W-2 or 1099. A thorough parsing of the relevant section 409A rules shows that this approach should avoid the various traps otherwise set by the substitution rule of the section 409A regulations.

8. Clawbacks of employer stock and other property subject to section 83 raise special issues if the property has appreciated or depreciated after being included in income on vesting under section 83(a). Generally, the employee is entitled to a deduction equal to his basis in the shares. If the property has depreciated, however, some section 1341 treatment (computing the exclusion from prior year's income) is limited to the FMV of the shares at the time of clawback. If the employee has made a section 83(b) election, no deduction is available, except that for nonvested shares, a deduction for any amount paid for the shares is taken as a capital loss.

9. FICA taxes previously paid on the relinquished amounts — both the employer's and employee's shares — can be recouped under IRS procedures for mistaken overpayments of FICA taxes. This is the case even though the payment was correct when made and was only later determined to be an ''overpayment'' via imposition of the clawback. To recoup FICA taxes, the employee must repay the ''overpayment'' to the employer — in this case, the clawed-back amount. While it is not entirely clear whether the repaid amount is computed net or gross of the FICA taxes initially withheld, recent IRS guidance suggests that repayment *net* of the withheld FICA taxes is sufficient.