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CHAPTER 1C

Payback Time: Tax Treatment of Executive Compensation Clawbacks

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Synopsis

§ 1C.01 INTRODUCTION

§ 1C.02 SUMMARY OF DISCUSSION

§ 1C.03 DETAILED DISCUSSION

[1] Clawbacks of Same-Year Payments

[2] Clawbacks of Prior-Year Payments

[a] Employee Cannot Amend Tax Return for Year of Payment

[b] Revenue Ruling 79-311: No Offset for Tax Reporting Purposes

[c] Itemized Deduction—Availability and Mechanics

[d] Section 1341 Relief—Mechanics

[e] Is Section 1341 Relief Available for Clawbacks?

[i] Statutory Requirements for Section 1341 Relief

[ii] IRS Requirement: "Apparent Right" Test

[iii] Problems with IRS Apparent-Right Test

[iv] Applying IRS Guidance to Clawbacks

[v] Case Law: The Same-circumstances Test

[vi] Applying the Same-circumstances Test to Clawbacks

[f] Repayment Set-off from Later Compensation

[i] Applying Revenue Ruling 79-311 to Set-offs

[ii] Netting Set-offs from Gross Income

[A] Constructive Receipt
[B] Cancellation of Indebtedness
[C] Assignment of Income
[iii] In Support of Tax Netting: *Ox-Fibre Brush* and the Reasonable Compensation Cases
[iv] Cautions and Constraints on the Tax Netting Approach
[g] Employer's Tax and Reporting Treatment
[i] Employer takes deduction back into in come
[ii] CD&A Reporting Requirements
[3] Retroactive Clawbacks: Special Issues
[a] Itemized Deductions and the Problem of "Voluntary" Repayments
[i] Retroactivity and the Unreasonable Compensation Cases
[ii] Unreasonable-compensation Cases are Distinguishable
[iii] Not "Voluntary" if Precondition for Other Compensation
[iv] Bottom Line: Retroactive Clawbacks are Likely Deductible Under Section 162 or 165
[v] Retroactive Clawbacks and Section 1341
[4] Bad Boy Clawbacks: Special Issues
[a] Employee's Deductions
[b] Section 1341 and the Claim-of-Wrong Rule
[5] Retirees and Other Former Employees: Special Issues
[a] Anticutback Clauses
[b] Itemized Deductions and Former Employees
[c] Section 1341 and Former Employees
[6] Section 409A and Set-offs from Nonqualified Deferred Compensation
[7] Repaying Employer Stock and Other Property—Special Issues
[8] FICA Tax Consequences
§ 1C.04 PRACTICAL CONCLUSIONS

§ 1C.01 INTRODUCTION

Compensation clawbacks have long been a key enforcement tool of corporate governance. A clawback policy embodies the employer's right to recover compensation paid to an employee. Traditionally, clawbacks have been used to punish bad behavior. For example, typical corporate policies have provided for recoupment of bonuses or severance pay upon an executive's breach of a non-competition, non-solicitation or confidentiality agreement, upon conduct that is illegal unethical or disloyal, or upon acts that are injurious to the financial or reputational health of the company. Some clawback polices are triggered by behavior as broadly defined as "breach of company policy."

But recent bonus recoupment policies have reached well beyond the traditional

realm of bad boy clawbacks. In response to corporate scandals of the last dozen years, Congress has weighed in to require clawbacks in a growing number of situations affecting a widening circle of executives. Section 304 of the Sarbanes Oxley Act of 2002 requires the CEO and CFO of a publicly traded corporation to disgorge certain bonuses following an earnings restatement caused by material noncompliance with financial reporting laws.[1] The SEC has successfully argued in federal district court that Section 304 applies even when the CEO and CFO are themselves blameless of personal wrongdoing.[2]

In 2010, Congress further expanded the reach of no-fault clawbacks by enacting Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[3] Section 954 requires every publicly traded company to develop a clawback policy. The policy must provide that, upon a material financial restatement, the company will recover from every current and former executive officer any incentive-based compensation paid in the three year period preceding the restatement. 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 SEC has as yet issued no guidance on Dodd-Frank clawbacks, leaving many key questions unanswered as to their reach. Will clawbacks apply retroactively to bonuses paid before the policy is in place? Who is an executive officer? How will clawbacks be measured for equity compensation?

The rapid expansion of no-fault clawbacks throws a spotlight onto the complex and uncertain tax treatment of bonus repayments for affected executives. Before, the costs and risks of this murky tax law were borne only by misbehaving executives punished for corporate wrongdoing. But Dodd Frank and similar corporate policies now extends the reach of clawbacks to an as yet undefined class of executive officers, without regard to blame, value to the company, or personal conduct. With an eye to these employees, the employer may wish to consider the tax treatment of compensation clawbacks, and design its clawback policy, as well as its tax reporting and withholding policy, so as to minimize tax risk and tax pain for these employees. This article is intended to set forth the multiple tax issues raised by clawbacks and the practical solutions for addressing them.

§ 1C.02 SUMMARY OF DISCUSSION

Because this article is somewhat lengthy and complex, and many readers will be seeking a practical bottom line, we here summarize the many tax issues raised by

[1] July 30, 2002, 107 P.L. 204, Title III, § 304, 116 Stat. 745.

[2] *SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

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

clawbacks, and their solutions. Section 1C.04 ("Conclusions") repeats this exercise.

Repayment of same year's compensation. Section 1C.03[1] sets forth the tax treatment of clawbacks applied to compensation receive in the same year. 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 the W-2. This wage and income exclusion applies whether repayment is held-back from other compensation or tendered directly from employee to employer.

Repayment of prior year's compensation. If the employee repays compensation paid in a prior year, the employee may not amend his tax return filed for the year of the original payment. Moreover, the IRS takes the position under Revenue Ruling 79-311 that the employer must include the repayment in the gross income and wages reported on the employee's W-2 for the repayment year; the repayment may not be netted from income and wages. The employee is accordingly subject to income and FICA taxes on income and wages ultimately relinquished. The employee may generally reduce the income tax on the relinquished payment by claiming the repayment as an itemized deduction, subject to the 2%-floor for miscellaneous itemized deductions, and the alternative minimum tax (AMT). In some circumstances, the employee may be made entirely whole for income taxes paid by claiming relief under section 1341.

Section 1C.03[2] addresses three issues arising generally with respect to the tax treatment of all clawbacks: The first issue (discussed at section 1C.03[2][e]) is the availability of Section 1341 relief. The IRS's confused and inconsistent rulings on section 1341 relief makes the IRS somewhat uncertain. By contrast, the same-circumstances test applied by case law (and some IRS rulings) should allow section 1341 relief for most clawbacks.

The second issue (at section 1C.03[2][f]) is whether the gross income-inclusion approach of Revenue Ruling 79-311 is required for all clawbacks, especially for those enforced by being deducted or "set off" from other compensation payable to the employee (rather than tendered directly by the employee via check or cash). This question may be of interest to employers seeking to avoid the multiple tax uncertainties arising for affected employees as to the deductibility of clawbacks. Surprisingly, while the gross income-inclusion approach of Revenue Ruling 79-311 is safe, it is not entirely clear that it is required. Instead, when a clawback is deducted or setoff from other compensation, the employer is arguably permitted to report the remaining compensation on net basis, after set-off. It should be noted that the multiple tax uncertainties of the Revenue Ruling 79-311 approach all fall on the employee. By contrast, the certainties of the alternative, tax netting approach fall on the employer; if the IRS disagrees, the employer will have failed to fulfill any withholding obligations on the set-off amount. Many employers and their advisors will wish to skip this discussion, and turn to the many special issues summarized immediately below.

Section 1C.03[2][g] summarizes the employer's tax treatment and proxy disclosure

reporting obligations under regulation S-K arising when compensation is recouped via clawback.

Retroactive clawbacks—special issues. Some companies may wish 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). Section 1C.03[3] discusses whether the employee may claim a deduction for these retroactive clawbacks. We conclude that—despite some troublesome authorities—the employee can likely claim an itemized deduction under section 162 or 165(c)(1). Somewhat more problematic is whether the make-whole deduction under section 1341 is available for retroactive clawbacks. The current IRS position is not entirely clear and might possibly preclude section 1341 relief. Under the same-circumstances test of controlling case law, however, section 1341 should apply for many or most retroactive clawbacks.

Bad boy clawbacks—special issues. Section 1C.03[4] discusses clawbacks imposed when an employee or former employee breaches an employment contract, severance agreement—for example, a covenant not to compete—or engages in other detrimental conduct Repayments under these bad boy clawbacks are deductible by the employee. The availability of section 1341 is somewhat more doubtful. Again, the (apparently current) IRS standard would arguably deny section 1341 treatment, while under controlling case law section 1341 should apply. In rare and egregious situations, where the clawback is triggered by criminal behavior, the "claim of wrong" rule may preclude section 1341 relief.

Retirees and other former employees—special issues. Section 1C.03[5] discusses clawbacks enforced against former employees. While 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.

Section 409A—Special Issues. If the employer enforces a clawback by reducing compensation, and the compensation being reduced is nonqualified deferred compensation subject to section 409A, a potential 409A issue arises. While unclear, it is possible that the set-off may implicate the substitution rule of 409A regulations. The safe way to avoid this potential section 409A pitfall is to include the set-off amounts in the wages and gross income reported on the employee's W-2 (or 1099), in compliance with Revenue Ruling 79-311. This issue and its safe solution addressed in Section 1C.03[6]. In addition, Section 1C.03[6] discusses some conceptual holes in the 409A substitution rule—a discussion that may be safely skipped by the practitioner seeking the practical side of this article.

Employer stock—special issues. Section 1C.03[7] 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 included in income.

FICA taxes. Section 1C.03[8] addresses the procedures for avoiding double FICA taxation on clawed back amounts. Specifically, 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 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 is permitted of the original payment net of the original FICA taxes.

Practical conclusions: What to do. Section 1C.04 summarizes the practical conclusions for employers and their advisors attempting to fashion a comprehensive and enforceable policy for clawbacks and their correct tax treatment.

§ 1C.03 DETAILED DISCUSSION

[1] Clawbacks of Same-Year Payments

In the rare case, compensation will be repaid in the same year as first paid. This case is governed by the simplest rule. Under Revenue Ruling 79-311, the repaid amount is excluded from gross income and wages, and so treated for tax purposes a if never paid.[4] For example, assume a $100 thousand performance bonus paid January of 2012, and repaid by December 2010. This treatment applies whether the repayment is offset from other wages, or paid directly by the employee writing a check.

The IRS's position on same-year repayments is based on the seminal cases of *Couch v. Commissioner* and *Russell v Commissioner*.[5] Following these two decisions, a long line of cases has held that compensation repaid in the same year as paid is excluded from wages and gross income, and treated for tax purposes as if never paid. Later IRS guidance has consistently followed the Couch Russel doctrine and Revenue Ruling 79-311 with respect to compensation repaid in the same year as paid.[6]

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[4] Revenue Ruling 79-311, 1979-2 CB 25.

[5] *Couch v. Commissioner*, 1 BTA 103 (1924), *acq*. IV-1 C.B. 1 (1925); *Russel v. Commissioner*, 35 BTA602 (1937), *acq*. 1937-1 C.B.22. 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* August 10, 2009, 557, 571–574.

[6] *See also, e.g.*, PLR 200044007 (July 26, 2000); PLR 9313015 (December 23, 1992) (Under RR 79-311, lump sum relocation advance repaid in same year excludable from gross income and wages reported on employee's W-2); PLR 8422130 (February 29, 1984) (when advances received by physicians and repaid to hospital by year's end to the extent in excess of guaranteed amounts, *held*, advances not included in gross income and wages reported on W-2 to the extent returned in the same year as received under *Couch*, *Russel* and Revenue Ruling 79-311).

[2] Clawbacks of Prior-Year Payments

More typically, clawbacks will require repayment of compensation first paid in a prior year. Assume, for example, that in 2009, the employer adopts a policy providing for recoupment of performance bonuses paid for any year for which earnings are later restated. The employee receives a $100 thousand performance bonus for 2010. Assume that 2010 earnings are later restated, and the employee is forced to repay the $100 thousand in 2012.

[a] Employee Cannot Amend Tax Return for Year of Payment

Even though the $100 thousand received and taxed in 2010 is restored to the employer, the employee is not permitted to amend her 2010 tax return. The reason lies in the longstanding "claim of right" doctrine. This doctrine provides that if a taxpayer receives a payment "under a claim of right and without restriction as to its disposition," the payment is includible in gross income in the year received, even if repaid in a later year.[7]

The claim of right doctrine does not apply for FICA tax purposes; the employee's ability to adjust her 2010 FICA taxes is discussed in section G.

The claim of right doctrine applies broadly. The employee in this example is considered to have received the $100 thousand bonus under a "claim of right" even though her original right to the bonus was contingent because subject to a pre-existing clawback policy,[8] and even assuming the bonus was originally paid under a mutual mistake of fact—say, a belief shared by all parties in good faith that 2010 earnings were correctly stated.[9]

Although the employee may not adjust her taxes for the year of the original payment, she is generally permitted to reduce taxable income for the year of repayment.[10] The threshold question is how this reduction is computed. May the employee offset the repayment for tax purposes from other wages payable by the employer in the repayment year, so that wages and income reported on her W-2 are reported net of the repayment? Or is her gross pay reported as wages and income on her W-2, and prior years' taxes recouped, if at all, only if the employee can claim a deduction for them? The answer may significantly affect the employee's tax situation.

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

[8] *See, e.g.*, *McCormack v. Commissioner*, TC Memo 1987-11 (when advance fees received subject to contingent repayment obligation if payee fired by payor during two-year period, *held*, advance taxable under claim of right); *Phillips v. Commissioner*, T.C. 767, *aff'd* 238 F2d 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).

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

[10] James v. United States, 366 U.S. 213, 220 (U.S. 1961).

Surprisingly, the answer is not entirely clear and the authorities not entirely consistent. Revenue Ruling 79-311 sets forth the tax treatment of taxable advances repaid by the employee to the employer pursuant to an employment agreement, at the termination of the employment relationship. Under Revenue Ruling 79-311, compensation in the repayment year is reported gross of (without netting) the repayment; the employee recoups income taxes paid on the initial payment by claiming a deduction (if available). If the payment year is still open, the employer initiates a FICA tax refund under Code section 6413 for both the employer and employee's share FICA taxes paid on the initial payment.

It is not entirely clear, however, that Revenue Ruling 79-311 is mandatory when repayments are held back or "set off" from other compensation payable in the repayment year rather than being tendered by the employee by check or cash. When repayment is by setoff, tax netting is arguably permitted. from other compensation payable in the repayment year. Moreover, the very sketchy case law arguably supports a netting approach in this case.

The following discussion details both the approach set forth in Revenue Ruling 79-311, and the alternative netting approach. The risk-averse employer and its advisors, of course, will prefer to follow the Revenue Ruling 79-311 method set forth in subsections (2) through (5). While this approach raises many questions, as will be seen, they affect the tax treatment of the employee only. by following Revenue Ruling 79-311 the employer ensures that its own withholding obligations, if any, are satisfied The alternative netting approach set forth in subsection (6) may be safely skipped by those readers who wish to minimize tax uncertainty for the employer.

[b] Revenue Ruling 79-311: No Offset for Tax Reporting Purposes

Revenue Ruling 79-311 sets forth the IRS position for repayments of compensation first paid in a prior year. The repayment may not be offset or netted from the income and wages reported on the employee's W-2 for the later year of repayment. The employee recoups income taxes paid on the restored payment only by claiming a deduction for the repayment. The IRS has applied Revenue Ruling 79-311 in numerous rulings setting forth the tax treatment of repayments of prior years' payments.[11]

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[11] Revenue Ruling 79-311, 1979-2 CB 25 (when advances paid to employees exceeded earned commissions, and were repaid upon termination of employment pursuant to contact agreement, *held*, when repayments made in year after year advance first paid, employer may not report repayment as reduction from gross income and wages reported on employees' W-2s for the repayment year; employee can claim deduction for repayment under I.R.C. § 162(a)(1), and can also claim credit for employee's share of FICA taxes withheld from advance, under Treas. Reg. § 31.6413(a)-1(b)(i)); GCM 36851 (September 17, 1976) (GCM underlying Revenue Ruling 79-311, reaches same conclusions. but suggests that deduction for repayment available under either 162(a) or 165(c)(1)); 2001 IRS CCA Lexis 302 (June 15 2001) (when bonuses paid in earlier year repaid in later year pursuant to settlement of civil litigation,

For example, assume that, in 2012, the employee in the above example repays the $100 thousand performance bonus first paid for 2010, and earns gross pay of $1 million, leaving her with net 2012 compensation of $900 thousand. Using the method set forth in Revenue Ruling 79-311, her employer will report her Form W-2 income and wages as $1 million, rather than the net $900 thousand. She may deduct the $100 thousand clawback to the extent permitted by section 162(a) or section 165(c)(1), subject to the 2% floor, and the alternative minimum tax (AMT). She may avoid the limitations of the 2% floor and AMT in some circumstances by claiming relief under Section 1341.

[c] Itemized Deduction—Availability and Mechanics

If the employer follows Revenue Ruling 79-311, the employee can recover income taxes paid on the clawed back amount only by claiming an itemized 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.[12] An employee can thus claim a deduction for repayments of earlier-paid compensation, either as an unreimbursed business expense under section 162,[13] or as a loss incurred in trade or business under section 165(c)(1).[14] In any event, the question has no practical significance, since the same constraints apply to both sections[15]

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held, there is "no exclusion from income in the year repaid"; employee can recoup taxes on previously received amounts only by claiming deduction for repayment); PLR 200044007 (July 26, 2000); PLR 9313015 (December 23, 1992) (when lump sum relocation advance repaid in later year upon voluntary termination according to agreement in force at time advance paid, *held*, repayment deductible in accordance with Revenue Ruling 79-311); PLR 9103031 (October 23, 1990) (where bonus overpayments mistakenly paid to certain employees in one year, and repaid in the subsequent year by being back from salary payments, *held*, under Revenue Ruling 79-311, the setoffs were included in the income and wages reported on affected employees' W-2 for the year, rather than excluded from Section 61 gross income; affected employees could claim itemized deduction for held back amounts, subject to 2% floor, etc.).

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

[13] *See. e.g., Adams v Commissioner*, 58 T.C. 41 (1972); Revenue Ruling 79-311.

[14] *See, e.g.*, GCM 36851 (underlying Revenue Ruling 79-311, reaches same conclusion but would allow repayment to be deducted under either I.R.C. § 162(a) or 165(a)(1)). Rev. Rul. 82-178, 1982-2 CB 59 (repayment of severance by rehired employee, deductible under section 165(a)(1) as a loss incurred in employee's trade or business); Rev. Rul. 79-322, 1979-2 CB 76 (Held, amounts paid by Federal Employee repurchase sick leave pay received in an earlier year, deductible under section 165(a)(1)); Revenue Ruling 67-48 1967-1 CB 50 (when an employee who repaid wages received in 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, 2002-2 CB 953. (When qualified pension plan makes erroneous overpayment to retired employee, and employee repays directly in later year, held repayment is deductible under 165(a) because "the amount of the plan overpayment is attributable to compensation for services rendered to the employer.)

[15] In addition to sections 162 and 165(c)(1), some early case law appears to treat section 1341 as an

Whether claimed under section 162 or 165(c)(1), the deduction may be taken only "below the line," as a miscellaneous itemized deduction under Code section 67. Either deduction is subject to the 2% floor of section 67, and is a preference item for (i.e., is not a permitted deduction) the taxpayer's alternative minimum tax.[16] Accordingly, the employee may be subject to significant double taxation on clawed back compensation, even if the repayment is deductible, unless the employee can also claim relief under section 1341.

[d] Section 1341 Relief—Mechanics

Section 1341 was enacted in response to perceived inequities of the claim of right doctrine. Even if the taxpayer deducts a restored payment in the restoration year, the deduction may not make him or her whole for income taxes paid. For example, if $100 is paid and taxed in a year when the taxpayer's marginal rate is 50%, and repaid and deducted in a later year when his marginal rate is 25%, the taxpayer has paid income tax of $25 on income ultimately relinquished and is not made whole.

Section 1341 provides make-whole relief for the income tax paid on restored payments, including relief from the impact of changing marginal tax rates. Section 1341 allows the repaying taxpayer to compute income tax in the repayment year as the *lesser* of the tax computed by deducting the repayment for that year (Section 1341(a)(4)), or the tax computed without the claiming the deduction, but reduced by a tax credit equal to the income tax attributable solely to the payment in the taxable year it was received (under Section 1341(a)(5)). When marginal tax rates are higher in the payment year than in the repayment year, the tax credit computation is generally more favorable; when lower in the payment year than in repayment year, the deduction computation is generally better[17]

Section 1341 relief allows the employee in our example to deduct the claw-back without the limitations of the 2% floor and the AMT. This is true whether she uses the deduction prong of section 1341(a)(4), or the tax credit prong of section 1341(a)(5). In computing the deduction under section 1341(a)(4), the repayment is excluded from miscellaneous itemized deductions defined under section 67 and subject to the 2% floor.[18] Because not a section 67 miscellaneous itemized deduction, the section 1341

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independent ground for deducting repayments of amounts received in an earlier year. These cases are incorrectly reasoned to this extent, because section 1341 is available only for repayments for which a deduction is already allowed under some other Code section. I.R.C. § 1341(a)(2); *U.S. v Skelly Oil Co*, 394 U.S. 678, 683 (1969).

[16] I.R.C. § 56(b)(1)(A)(i).

[17] 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.

[18] I.R.C. § 67(b)(9), Treas. Reg. § 1.67-1T(b)(14); SCA 1998-026.

deduction it is not a preference item for purposes of the AMT.[19] In computing the tax credit under section 1341(a)(5), the employee recomputes income tax for the year of initial payment, excluding the payment from income for that year. The IRS has explained that the section 1341(a)(5) credit applies for purposes all taxes under Title I, including the AMT.[20] The 2% floor of course does not apply, because the recomputation is an income exclusion rather than a deduction.

Section 1341 relief applies in full even if the tax reduction in the repayment year exceeds the amount of taxes otherwise owed in that year. If the credit under section 1341(a)(5) exceeds taxes owed for the restoration year, the excess is a refundable credit.[21] If the deduction under section 1341(a)(4) results in a net operating loss (NOL) for the restoration year, regulations provide for NOL carryback and tax credit treatment.[22]

[e] Is Section 1341 Relief Available for Clawbacks?

When claiming an itemized deduction for the clawback, the employee is made-whole for income taxes only if section 1341 applies. Does it?

As we will show, the IRS position on this point is not clear. The likely answer is that section 1341 relief generally applies, but uncertainty applies. Moreover, under the IRS position, section 1341 may not be available for clawbacks in situation when the repayment obligation arises after the initial payment This category includes, for example, "retroactive" = clawbacks of compensation paid before the clawback policy was announced, and "bad boy" clawbacks triggered by post-payment breaches of contract or company policy. By contrast, the very different test applied by the case law would allow section 1341 for most clawbacks.

[i] Statutory Requirements for Section 1341 Relief

Section 1341 applies if three requirements are met: the repayment exceeds $3,000; it "appeared" that the taxpayer had an unrestricted right to such 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)).

Section 1341 applies only to payments already deductible under another Code section. Thus, the employee first determines that the clawback would be deductible under section 162 and 165, and only then may determine whether section 1341 is available.[23]

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[19] I.R.C. § 56(b)(1)(A)(i).

[20] FSA 200129001 June 23, 2001.

[21] Treas. Reg. § 1.1341-1(i).

[22] Treas. Reg. § 1.1341-1(b)(1)(ii) and (iii).

[23] I.R.C. § 1341(a)(2); *U.S. v Skelly Oil Co*, 394 U.S. 678, 683 (1969).

[ii] IRS Requirement: "Apparent Right" Test

The IRS has long held that section 1341 applies to repayments only when the taxpayer had an "apparent" but not an "actual" right to the payment when received. Both prongs must be satisfied. For example, Section 1341 relief does not apply to an embezzler's restitution of funds embezzled in a prior year, because he lacked even an "apparent" right to the stolen funds.[24]

Applying the distinction between an "apparent" and actual" right, numerous IRS rulings have held section 1341 does not apply when the taxpayer's unrestricted right to income in the payment year was defeased only in a later year by a "subsequent event." The IRS reasons that in this case the taxpayer's right in the year of payment was "actual" rather than apparent and section 1341 does not apply.

For example, Revenue Ruling 69-115 held that section 1341 does not apply when an employee/shareholder returns prior year's salary pursuant to an agreement to restore compensation later determined by the IRS to be "unreasonable." The ruling reasons that the shareholder had an unrestricted right to the salary when received; repayment was required only because of the IRS's "subsequent: administrative determination the salary was unreasonable.[25] Similarly, Revenue Ruling 67-48 held that section 1341 does not apply to an employee's repayment of prior year's wages as liquidated damages for contract breach in a later year. The ruling reasons that the employee's right to the wages was unrestricted in the year of receipt, and defeased only by the subsequent breach.[26] Numerous other rules illustrate the IRS position that the section 1341 does not apply when the repayment obligation is caused by an event subsequent to the year of the original payment[27]

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[24] Rev. Rul. 65-254, C.B. 1965-2, 50.

[25] Revenue Ruling 69-115, 1969-1 CB 50 (employee/shareholder who returned earlier years' salary to the employer (i.e., the corporation of which he was a shareholder) pursuant to an agreement, in effect when the salary was paid, that the salary would be repaid if later determined by IRS to be nondeductible. Citing Revenue Ruling 67-48, *held* 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 upon a subsequent event (the IRS's non-deductibility determination).

[26] Ruling 67-48 1967-1 CB 50 (when excess wages, initially paid in expectation of employee's serving for contractually-agreed service period, are repaid to employer as liquidated damages by employee for breach of service contract, *held*, payment deductible under 165(c)(1), but section 1341 not available because employee in fact had right to such excess wages when they were received; repayment caused by the "subsequent event"—*i.e.*, the breach).

[27] Revenue Ruling 67-437 1967-2 DB 296 (when salary earned in one year is repaid to employer in later year pursuant to agreement that repayment would be made if amounts determined by IRS to be nondeductible, *held* 1341 relief not available because taxpayer had "unrestricted right" in year of receipt, and repayment obligation triggered by subsequent event); Revenue Ruling 58-226, 1958-2 C.B 318 (refund of prepaid interest on ten year note, where prepayment of principal in subsequent year, held, 1341

[iii] Problems with IRS Apparent-Right Test

The IRS position that section 1341 does not apply when repayment is caused by an event subsequent to payment has generally been rejected by the case law.[28] Before discussing the courts' view of section 1341, we discuss first the numerous deficiencies with the IRS position, in particular, its conceptual flaws and its inconsistent application by the IRS.

The IRS's subsequent-event test is based on the premise that a right is not "apparent" if it is actual. The purported distinction between "actual" and "apparent" rights is a flawed reading of the statutory requirement that section 1341 applies when taxpayer "appeared" to have an "unrestricted right" to income.[29] The better and more logical view is that "actual" rights are a subset of "apparent" rights—namely those rights that are apparent because also actual. In rejecting the IRS's attempt to distinguish between the two, the Fourth Circuit observed that the appearance of a right can include "an appearance that happens to be true."[30] The Eight Circuit and Seventh Circuit found the same deficiency with the apparent/actual right distinction.[31]

Moreover, IRS's many attempts to define what constitutes a "subsequent" event are baffling and inconsistent.

For example, Revenue Ruling 69-115 holds that, when an employee/shareholder restores salary pursuant to an agreement with his employer for any salary later determined by the IRS to unreasonable, the IRS unreasonableness determination is a "subsequent event." But the analysis of other rulings implies that subsequent administrative determinations are not necessarily subsequent events. As explained by TAM 9516002, Section 1341 applies if, under the "facts in existence" at the time of the payment, the taxpayer had no actual right to the payment, but this was not known

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not available, because taxpayer "in fact and in law" had right to money when received, instead of "appearance" of right as required by 1341(a)(1). For this reason, fails 1342(a) requirement that his absence of right in prior year be "established after the close" of the year, because liability to repay "accrued" in later year), because taxpayer had unrestricted right to prepaid interest, and repayment obligation triggered by subsequent event (namely prepayment of principal); Revenue Ruling 68-153, 1968-1 CB 371 (situation 4: when railroad restores freight charges earned in one year because a later year's transit adjustment retroactively imposes a lower rate for that year, *held*, section 1341 does not apply).

[28] *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 364 (4th Cir. 2000) (the statute does not require that the facts according to which the taxpayer lacks an unrestricted right to certain income must have existed in the prior tax year.").

[29] I.R.C. § 1341(a)(1) (section 1341 applies if "an item was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to such item.").

[30] *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 363–68, (4th Cir. 2000).

[31] *See also MidAmerican Energy Company v. Commissioner*, 271 F.3d 740, 744 (8th Cir 2001) (similar, in dictum), *WICOR, Inc. v. United States*, 263 F.3d 659, 663 (7th Cir. 2001) (similar, in dictum).

at the time.[32] Under this analysis, the later administrative determination is not a subsequent event in its own right, but rather a discovery of the facts in existence at the time of payment, and section 1341 should apply. The analytical approach of TAM 9516002 was indeed followed in at least one holding of Revenue Ruling 68-153.[33] In "Situation 3" a shipping charge that was "legally proper" under then "facts then available" to the shipper was retroactively determined by the rating agency to be incorrect, requiring payment of "reparations" to customers. Section 1341 applies. The ruling explains that the shipper had a "semblance" of unrestricted right in the payment year, and "it could not be established in fact and in law until a subsequent year" that this right did not then exist.

Applied to the taxpayer in Revenue Ruling 69-115, the facts-in-existence analysis of TAM 9516002 and (apparently) Revenue Ruling 68-153 would produce a different outcome than the Revenue Ruling 69-115 holding. Under the facts in existence when paid, the taxpayer's salary was unreasonable, even though this fact was unavailable to the taxpayer until the IRS's later determination, and section 1341 accordingly should apply.[34] The IRS has further compounded the confusion by ruling that that, when a taxpayer has an apparent but not an actual right to payment, but the appearance arises only because the taxpayer made a "mere" arithmetic error, section 1341 does not apply.[35]

These fluctuating and inconsistent applications of the apparent-right test arise in part, we think, because "facts" and "events" are typically not raw data, but rather judgments comprising legal, financial, and other administrative determinations. The attempt to distinguish facts in existence from subsequent events gives rise to definitional problems that in the section 1341 arena, the IRS has failed to address.[36]

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[32] TAM 9516002 (explaining that *Van Cleave* is not repudiation of 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, taxpayer's return of salary was not caused by a "subsequent event.") 1995 FSA Lexis 268 (November 27, 1995) (when employee receives tax equalization payment from employer subject to contractual obligation to repay to employer of taxpayer gets refund, held, 1341 available to repayment under *Van Cleave*).

[33] 1968-1 CB 371.

[34] TAM 9516002 applies this reasoning to explain that section 1341 applies to a taxpayer with facts very similar to the taxpayer in Revenue Ruling 69-115—that is a taxpayer who returns compensation later determined by the IRS to be unreasonable.

[35] Ruling 68-153, 1968-1 CB 371 (situation 2). PLR 200901029 (September 20, 2008).

[36] In the accrual accounting arena, the authorities have been forced to grapple with this issue, since a payment defeasable by a condition subsequent has typically met the all-events test. Even for purposes of the all-events test, however, the distinction between a condition subsequent and a condition precedent is not entirely consistent in all circumstances.

Moreover, the IRS does not always apply its own test. For example, Revenue Ruling 72-28 holds that section 1341 applies to a salesman's repayment of advance commissions when the restoration is caused by customers' subsequent failure to pay.[37] Revenue Ruling 72-28 is inconsistent with the subsequent event test and the underlying distinction between actual and apparent rights. Revenue Ruling 72-28 is however, consistent with the same-circumstance test applied by the case law and discussed below. Revenue Ruling 2004-17 expressly breaks step with the subsequent event test, and holds that the correct test is the same-circumstances test of case law. Under the subsequent events test as applied in these rulings (although not named in Revenue Ruling 72-28) section 1341 should apply to the clawback.

[iv] Applying IRS Guidance to Clawbacks

Applying IRS guidance, with its conceptual confusion and inconsistent application, leaves some uncertainty as to the IRS position on the application of section 1341 to clawbacks.

Return to our example above, in which, pursuant to a clawback policy in place before 2010, the employee's $100 thousand bonus for 2010 is clawed back in 2012 because 2010 earnings are restated, Assume that none of the $100 thousand bonus would have been paid had earnings been correctly stated, hence her return of the entire amount. Does section 1341 apply to her 2012 clawback?

Applying Revenue Ruling 69-115 to this example, the earnings restatement is arguably a subsequent event defeasing the employee's unrestricted right to her bonus when paid; section 1341 does not apply to the repayment. But applying the approach of TAM 9516002 and Revenue Ruling 68-153, Situation 3, she was not entitled to the $100 thousand bonus under the company's correctly stated earnings in the year of payment, and would not have received it had those actual earnings been then known. Under this analysis, the earnings restatement is not a subsequent event but a later discovery of facts in existence at the time of payment, and section 1341 applies to the repayment.

And finally, applying the very different test of Revenue Ruling 72-78 and Revenue Ruling 2004-17, the question whether the earnings restatement is a subsequent event is irrelevant. As explained by Revenue Ruling 2004-17, the correct question is whether her obligation to repay arose from the "same circumstances and conditions" of the original payment. In this case the answer is yes. The bonus was contingent on assumed earnings targets being met, the repayment obligation arose when it was determined that these targets were not in fact met Under Revenue Ruling 72-78 and 2004-17, Section 1341 should therefore apply.

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[37] Revenue Ruling 72-78, 1972-1 C.B.45 (when salesman receives advance commissions, but repays portion in later year because some customers failed to pay their obligations, held, repaid amounts are deductible under section 162 and eligible for section 1341).

The IRS position raises even more questions for clawbacks of amounts paid before the clawback obligation is triggered. This troublesome category includes bad-boy clawbacks, clawbacks for breaches of covenants not to compete, and other clawbacks triggered by undesirable behavior or breach arising after the payment. For example, consider an employee who receives a severance bonus which must be repaid if the former employee enters employment with a competitor in the three-year period following severance. Under the apparent right test, the taxpayer's right when paid was "actual" even if contingent on future good behavior. Since the repayment obligation is triggered only by subsequent bad behavior, section 1341 should not apply. Similar questions arise for "clawbacks imposed on compensation paid before the contingency policy was in place. Such "retroactive" clawback would apply in our first example (i.e., 2010 performance bonuses clawed back if 2010 earnings are restated) if the employer's clawback policy was put in place only in 2012, and applied to compensation earned in 2010 and paid in 2011.

[v] Case Law: The Same-circumstances Test

Those courts to have reviewed section 1341 have rejected the IRS's distinction between actual and apparent rights. Under case law, the preferred view is that section 1341 is available if the repayment obligation arises from "the circumstances, terms, and conditions of the original payment of such item to the taxpayer."[38] The same-circumstances test is less confused than the IRS apparent-right test, and applies even when the repayment obligation is caused by an event subsequent to the payment.

Dominion Resources nicely illustrates how the same-circumstances test applies when the repayment obligation is caused by an event subsequent to the original payment. *Dominion Resources* involved a regulated electric utility whose rates charged to customer included anticipated Federal income taxes at a 46% rate. When new law reduced corporate income tax rates prospectively, the utility was required by its regulators to rebate to customers a portion of previously collected utility charges (which had been based on the assumed 46% tax rate). The IRS denied Section 1341 relief for the rebate, reasoning that the utility had an" actual" right to the utility charges when received; the rebate obligation arose only from subsequent events, namely, new law reducing future tax rates, and the regulators' decision to require rebate of the formerly received premium charge. The Fourth Circuit rejected the IRS distinction between apparent and actual rights to income.[39] The court held that section 1341 was available because the charges received by the utility from customers, and the utility's

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[38] *Dominion Resources, Inc.*, 219 F.3d at 367, quoting *Pahl*, 67 T.C. at 290 and *Blanton*, 46 T.C. at 530.

[39] *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 364, (4th Cir. 2000) (the statute does not require that the facts according to which the taxpayer lacks an unrestricted right to certain income must have existed in the prior tax year.").

obligation to rebate a portion of those charges, both arose from the same circumstances, namely the utility's "liability to the federal government for deferred income taxes."[40] Accordingly, the rebate arose from the same "circumstances, terms, and conditions" as the initial payment, and section 1341 applied.

The same-circumstances test has been adopted by the Tax Court, and the Federal, Third, Fourth and Sixth Circuits.[41] The Eighth and Seventh Circuits have not expressly addressed the issue, but have in dictum rejected the IRS distinction between actual and apparent rights for section 1341 purposes.[42] To our knowledge, no Federal appellate opinion has adopted the IRS's distinction between actual and apparent rights.

Articulations of the same-circumstances test vary somewhat. In *Dominion Resources*, section 1341 applied to a rate rebate because the rates were received based on an implicit condition (corporate tax rates continuing to be 46%); and the rebate obligation arose from the failure of this condition to materialize (new law reduced corporate tax rates). In *Reynolds metal*, the district court explained that section 1341 applies only if the taxpayer's payment is restoration of the same item received in an earlier year.[43] In *Uhlenbrok*, the Tax Court explained that Section 1341 does not apply if taxpayer's payment obligation would have existed even absent receipt of earlier income he purports to repay; under this formulation, section 1341 applies if the original payment is the but-for condition of the later repayment.[44]

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[40] *Dominion Res., Inc*, 219 F.3d at 368 (Section 1341 satisfied because (i) 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.

[41] *Pahl v Commissioner*, 67 TC 286 (1976); *Uhlenbrock v Commissioner*, 67 T.C. 818 (1977); *Kraft v. United States*, 991 F.2d 292 295 (6th Cir. 1993) (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): Alcoa, Inc. v United States, 509 F.3d 173 (3d Cir. 2007); *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 364, (4th Cir. 2000).

[42] *MidAmerican Energy Company v. Commissioner* 271 F.3d 740, 744 (8th Cir 2001) (in dictum, declines to comment on IRS argument that "actual" right to income is not "apparent" right to income for 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, Inc. v. United States*, 263 F.3d 659, 663 (7th Cir. 2001) (in dictum, declines to comment on IRS argument that "actual" right to income is not "apparent" right to income for 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, Inc.*, *Van Cleave* and *Prince*.).

[43] *Reynolds Metal Company v. U.S.*, 389 F.Supp.2d 692, 702 (E.D. Va. 2005) (payment must be "repayment or restoration of an item of gross income included in prior years.").

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

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.[45]
- Section 1341 did not apply to a corporate officers penalty payment to the FTC, 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 such earlier-paid salary.[46]
- When the executor of an estate reimbursed the estate for a late-filing penalty imposed by the IRS, section 1341 was not available for the reimbursement because the penalty reimbursement was not repayment of previously-received commissions, and would have been required even if no commissions had been received.[47]
- Section 1341 was 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.[48]

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[45] *Reynolds Metal Company v. U.S.*, 389 F.Supp.2d 692 (E.D.Va. 2005) (1341 does not apply to environmental remediation costs, even though costs arise from earlier years business activities, because (1) 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 payors).

[46] *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 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.").

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

[48] *Kraft v. United States*, 991 F.2d 292 295 (6th Cir. 1993) (Section 1341 not available for restitution payment for fraud to Blue Cross, because item included in income (medical fees from Blue Cross) "did

[vi] Applying the Same-circumstances Test to Clawbacks

Under the same circumstances test, section 1341 should apply broadly to clawbacks. Return to the example for he employee whose 2010 performance bonus is clawed back in 2012 when 2010 earnings are restated. The clawback arises from the same circumstances and conditions as the bonus (assumed earnings or other performance target not in fact met), and section 1341 should apply. This should be the case whether the clawback policy was in place before the 2010 bonus was earned and paid.

Similarly, the same-circumstances test should generally cover clawbacks for breach and detrimental activity and other bad-boy clawbacks where the bad behavior arises after the initial payment. 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 non-compete agreement. Like the tax prepayment paid to the *Dominion Resources* utility, the severance bonus was paid in anticipation of certain future events (adherence to agreements), and the repayment was required because the anticipated event did not materialize (breach).

[f] Repayment Set-off from Later Compensation

In many cases, clawbacks will be enforced by being held back or set-off from other payments of compensation. Set-offs might 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 might be imposed unilaterally or involuntarily by the employer to enforce otherwise doubtful repayment. State wage payment laws may limit involuntary set-offs, particularly against base pay, but, depending on the state, may permit them against severance pay, bonuses, stock options or equity based plans.[49] Surprisingly, the tax treatment of such set-offs is not entirely clear, and the authorities not entirely consistent.

[i] Applying Revenue Ruling 79-311 to Set-offs

One approach would follow Revenue Ruling 79-311. Under this approach, held-back amounts would be included in the gross income and wages reported on the employee's Form W-2 (or 1099), even though not paid directly to the employee. Just as for direct repayments, the employee could claim the set-off as a deduction under section 162 or 165, and claim 1341 treatment where applicable.

Gross income inclusion for set-offs is indirectly but strongly supported by considerations of consistency. It makes their tax treatment identical to that required by

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not arise out of the same circumstances, terms and conditions" as restitution payment).

[49] For a discussion of the variety of constraints imposed by state wage laws, as well as other non-tax issues raised by clawbacks, *see* Richard E. Wood, "Bad Boys (and Girls) Get Clawed Back," 18 *Benefits Law Journal* 84 (Summer 2005).

Revenue Ruling 79-311 for direct repayment, thus observing the substance over form doctrine.[50] At least one private letter ruling has required gross income inclusion for set-offs: PLR 9103031 involved an employer who recouped mistaken overpayments of bonuses paid in a prior year by holding back the overpayments from salary otherwise payable in the repayment year.[51] PLR 9103031 held that under Revenue Ruling 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.)

[ii] Netting Set-offs from Gross Income

It is not entirely clear that repayments via set-off must be reported as included in gross income and wages under Revenue Ruling 79-311. This subsection explores the alternative, netting method, and its arguable validity.

First, IRS and the courts apparently agree that set-offs are netted from income and wages when the employee otherwise has no personal repayment liability. For example the *Drummond* and *Moorman* cases involved employees required by contract to repay unearned advances of commissions to their employer by having the unearned amounts held-back from commissions earned in a later year.[52] If the unearned advances exceeded the later year's earned commissions, the employees had no personal obligation pay the difference. The Tax Court held that the hold-backs were excluded from the wages and gross income reported on the employee's W-2. Since the advances were included in income when first paid, the Tax Court reasoned that, unless excluded when repaid, they would be taxed twice. 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 hold-back from the later-paid

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[50] *See, e.g.*, *Adams v Commissioner*, 54 T.C. 41 (1972) (When advance repaid by reducing consideration within section 337 liquidation sale between the parties, court rejected IRS argument that no deduction available, reasoning that, while "mode of repayment" was reduction of consideration in sale, "source" of reduction was obligation to repay advance and therefore deductible under section 162, further explaining, "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.").

[51] PLR 9103031 (October 23, 1990).

[52] *Drummond v. Commissioner*, 43 B.T.A. 529 (1941) (when employer held back commissions earned in one year to recoup unearned advances of sales commissioners paid in earlier year, and taxpayer had no personal liability to repay had advances, *held*, amount of hold-back not included in the taxpayer's gross income, *reasoning that*, since the advances were included in income in 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 TC 666 (1966), *acq.*, 1956-2 C.B. 7 (similar, citing *Drummond*).

amounts.[53] Both rulings held 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).[54]

In addition, the IRS has allowed set-offs to be netted from income even when the taxpayer has a personal repayment obligation. Revenue Ruling 2002-84 deals with repayments by retirees of overpayments from a qualified defined benefit plan. Revenue Ruling 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 set-offs are excluded from the gross income reported on the retiree's Form 1099.[55] Netting is permitted by the ruling 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).[56]

It is difficult to reconcile these authorities. Surprisingly, it is even more difficult to identify a convincing theory explaining why set-offs from current compensation to repay previously taxed compensation should *ever* be included in gross income (as under PLR 9103031) rather than excluded, as under *Moorman*, *Drummond* and Revenue Ruling 2002-84. In concluding that such setoffs were excludable, the *Drummond* court reasoned that otherwise the repaid amounts (which were taxed when first paid) would be taxed twice. Under this double-taxation concern, all repayments of previously taxed payments would be excludable from gross income, at least when set-off from current compensation.[57]

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[53] Rev. Rul. 80-9, 1980-1 C.B. 11 (when lump sum readjustment pay repaid via set off from later paid disability pay, *held*, readjustment pay netted from the disability pay reported in gross income). Revenue Ruling 67-350, 1967-2 CB 58 (when a military officer's retirement pay was, by statute, offset by 75% of any earlier-paid involuntary severance pay, *held*, retirement pay includible in gross income only net of such set-off).

[54] Recall Revenue Ruling 2002-84 (1) and (2), *supra*, 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. Revenue Ruling 2002-84 based its holding on the two military pay revenue rulings discussed in this paragraph. Revenue Ruling 2002-84, however, extended the holdings of these two earlier revenue rulings to a broader set of facts. The retiree in Revenue Ruling 2002-84 had a personal liability to repay the pension overpayment if later years' pension distributions were insufficient to cover.

[55] Rev. Rul. 2002-84, 2002-2 CB 953, Situations (1) and (2) (When erroneous overpayment of qualified defined benefit plan benefits repaid by being setoff from later-years' scheduled annuity payments, *held*, setoff amount each year properly netted from distribution reported on retiree's Form 1099 for that year, rather than included in gross income).

[56] Rev. Rul. 2002-84, 2002-2 CB 953, Situation (3) (where retiree received overpayment of lump sum, and overpayment repaid directly by retiree in subsequent year, *held*, repayment deductible under section 165(c)).

[57] *Cf. Aramony v United Way*, 86 A.F.T.R.2d (RIA) 5987 (S.D.N.Y. 2000). An ousted executive and

[A] Constructive Receipt

In GCM 36851, the IRS suggested a different rationale for the *Drummond* and *Moorman* holding. [58] GCM 36851 in dictum reasoned that taxpayers in both cases "never received nor had the right to receive" the set-offs used to repay the advances.[59] While not entirely clear, the GCM apparently reasons that where the taxpayer is personally obligated to satisfy the a repayment from the taxpayer's other resources, the taxpayer is in "constructive receipt" of amounts held back from compensation to satisfy an obligation payable from other, after-tax resources. Under this approach, taxpayers with a personal repayment obligation (Revenue Ruling 79-311) are in constructive receipt of amounts held back from other wages to satisfy the obligation, and accordingly taxable. Taxpayers with no such personal repayment obligation (Rev. Rul. 80-9 and Revenue Ruling 67-350, *Drummond*, and *Moorman*), are not in constructive receipt of the amounts held back and are not taxable.

Constructive receipt doctrine, however, fails as grounds for mandating income inclusion for setoffs. Most fundamentally, the doctrine must here assume what it concludes—it assumes that the employee is "owed" the current year's pay and relinquishes the payment it would otherwise have received. This begs the question of whether the hold-back is a reduction of current year's pay or repayment of prior year's pay. To put this another way, it fails to ask whether the employee is entitled to receive income in any one year, if the receipt is subject to a pre-existing obligation to repay it. The fundamental problem is that constructive receipt doctrine *cannot* answer this question, because the doctrine properly applies only to determine the *timing* of income receipt—specifically, whether amounts owing to the taxpayer may be properly

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his former employer simultaneously owed amounts to each other from previous years, pursuant to 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 its reasoning that otherwise the executive's repaid salary would be subject to double taxation. *Aramony* is poorly reasoned, however, and it is not clear that it applies beyond its specific facts.

[58] GCM 36851 (September 17, 1976). GCM 36851 underlies Revenue Ruling 79-311.

[59] This fact was not relevant to the *Drummond* and *Moorman* courts' treatment of the repayment. The *Drummond* opinion notes that the taxpayer had no "personal liability" to repay the advance. This fact was relevant only to the taxation of the *original* payment, and not to that of the repayment. Specifically, since 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, since includible when first paid, properly excludable when repaid in order to avoid double taxation GCM 36851 turns the *Drummond* logic on its head. Since the taxpayer had no "right to receive" the set offs, the GCM concludes that they were properly excludable from income. GCM 36851 thus stretched the court's reasoning (payment included when paid, therefore, excluded when repaid) to an unrelated conclusion (repayment excludable without regard to treatment of original payment).

deferred for tax purposes.[60] The doctrine does not apply to the issue, raised here, whether income is received in the first instance.[61]

[B] Cancellation of Indebtedness

Alternatively, a set-off to enforce a clawback could possibly be viewed as taxable cancellation of indebtedness. This theory too is unsatisfactory.

The original payment was included in income because received under a claim of right, and not as excludable indebtedness.[62] Therefore, the transaction does not fall under the rule of *Kirby Lumber*, applying to the discharge of the taxpayer's obligation to repay funds that were nontaxable when received. The rationale underlying *Kirby Lumber* is that the taxpayer in this situation has realized an accession to wealth and thus taxable gross income.[63] By contrast, the employee subject to clawback was taxed on the original receipt of funds. When the clawback is triggered, cancellation of the springing repayment obligation does not cause a nontaxable accretion to wealth, but rather prevents a decrease in wealth, and *Kirby lumber* does not apply.

The IRS has used precisely this reasoning to conclude that cancellation of a restitution obligation does not give rise to taxable discharge of indebtedness income.[64] Similarly, it is black letter law that cancellation of the obligation of a guarantor or surety does not give rise to discharge of indebtedness income Again, the reasoning is that, because the obligation is a springing one, without prior receipt of nontaxable funds, the entire transaction (obligation/forgiveness) does not increase the taxpayer's wealth, but merely prevents a decrease.[65] And even assuming that the springing

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[60] *See* Treas. Reg. § 1.451-2(a) (Under the doctrine of "constructive receipt," an individual is in receipt of income for tax purposes in the taxable 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" (Spring 1974), 29 *Tax Law Review* 525.

[61] Constructive receipt doctrine in any event falls apart as a technical matter Constructive receipt, for example, does not apply to income deferred pursuant to 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 Revenue Ruling 79-311, where unearned advances were required to be paid according to a pre-existing agreement. Even if applicable to waivers as well as deferrals of income (which is not the case) the doctrine would not apply if, pursuant to such agreement, the first dollar of commissions earned in the later year were reduced to repay the prior year's unearned advances.

[62] *See, e.g.*, *Lehew v Commissioner* (1987) TC 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).

[63] *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), I.R.C. § 61(a)(2).

[64] CCA 200402004 (January 9, 2004).

[65] Hunt v Commissioner, T.C. Memo 1990-248, Whitmer v. Commissioner, T.C. Memo 1996-83, SCA 1998-039 (April 1, 1998).

clawback obligation, and not the original payment, gives rise to "indebtedness,"[66] direct repayment of the clawback is deductible under section 162 or 165. Cancellation of the purported indebtedness is thus excludable from gross income under section 108(e)(2).[67]

[C] Assignment of Income

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). Under this theory, the employee whose current compensation is reduced to satisfy a repayment obligation to her employer is treated for tax purposes like the plaintiff whose judgment award is reduced to pay attorney's fees. The plaintiff in this situation is considered to have made an anticipatory assignment of income to his attorney, and is taxable on the set-off just as if he had received the funds outright and then written a check to cover attorney's fees.[68] Similarly, under this theory the employee would be treated as assigning his current compensation to his employer.

This theory too is unsatisfactory because the assignment of income doctrine apparently does not apply in the two-party context, such as this one between employer and employee.[69]

[iii] In Support of Tax Netting: *Ox-Fibre Brush* and the Reasonable Compensation Cases

The 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 earlier year and retrospectively viewed as underpaid. This same principle is recognized for income tax purposes, despite the

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[66] *Cf. Violette v. Commissioner*, TC Summary Opinion 2002-149 (when taxpayer received insurance proceeds, and was subsequently required to return them because insurer determined that amounts received under false pretense, *held*, debt was created, and insurer's decision that collection would be futile created debt cancellation income under section 108(a)).

[67] As discussed below in this article, for bonuses repaid pursuant to a clawback policy first imposed after the bonuses were first paid ("retroactive clawbacks"), it is possible that a deduction is not available under either section 162 or section 165, In this 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 F2d 110 (3d Cir. 1990) (cancellation of gambling debt not taxable under code section 108(a) where gambling debt not enforceable under state law).

[68] *Banks v. Commissioner* 543 U.S. 426 (2005).

[69] *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 Law Journal* Spring 1999.

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.[70]

When compensation is thus viewed as applying to the entire multi-year service relationship, the economic reality of clawbacks shifts. 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.

[iv] Cautions and Constraints on the Tax Netting Approach

We have just set forth the reasons why tax netting is arguably permitted for clawbacks accomplished by set-off. These argument is that, in the employment at will context, the employee is at no point guaranteed any particular level of compensation. In both practical experience and tax law, it is permitted to view compensation as remunerating multiple years of service. Therefore, a setoff against current year's compensation to enforce a clawback obligation can permissibly be viewed as a nontaxable cut in current year's pay. No income receipt theory is to the contrary.

Nonetheless, tax netting raises a couple of cautionary points. First and most obviously, if the IRS disagrees with the tax netting approach, and insists on application of Revenue Ruling 79-311, the risk of tax netting falls first on the employer who has failed to satisfy its withholding obligations. By contrast, the multiple tax uncertainties raised by Revenue Ruling 79-311 fall entirely on the employee.

Second, if set-off is made against nonqualified deferred compensation subject to 409A, Revenue Ruling 79-311 should be followed.[71] Even if reduced to satisfy a clawback obligation in excess of $5,000, any 409A-covered compensation should generally be reported as income on a Form W-2 or 1099, or a 409A violation will arise

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[70] *Lucas v Ox Fibre Brush Co.*, 281 US 115 (1930). See also, e.g., *Brewer Quality Homes, Inc. v. Commissioner*, T.C. Memo 2003-200 (2003); *Sunbelt Clothing Co. v. Commissioner*, T.C. Memo 1997-338 (1997).

[71] 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.

with consequent tax penalties on the employee. The specific reason is the anti-substitution rule of 409A regulations, and is explained in depth below at subsection D.[72]

Third, the employer should keep an eye on applicable securities laws.

[g] Employer's Tax and Reporting Treatment

[i] Employer takes deduction back into in come

If the compensation was deducted by the employer when first paid, and is then repaid by the employee pursuant to a clawback, and the repayment is included in the employee's income pursuant to Revenue Ruling 79-311 (whether or not the employee also claims a deduction), the employer must take into income the amount it deducted when the bonuses were first paid, under the tax benefit rule.[73]

[ii] CD&A Reporting Requirements

The SEC staff has expressly addressed the reporting treatment required for the Compensation Discussion and Analysis (CD&A) when an employer recoups a bonus received in a previous year, and the affected employee is a named executive employee whose compensation is subject to disclosure under Item 402(a)(3). The clawback should not be deducted from compensation reported for the repayment year on the Summary Compensation Table. Compensation reported with respect to the prior year affected by the clawback should be adjusted with a footnote to explain the clawback.[74]

[3] Retroactive Clawbacks: Special Issues

Some employers may apply their clawback policy retroactively to cover compensation first paid before the clawback policy was adopted. The question arises as to whether repayments pursuant to a retroactively imposed policy ("retroactive clawbacks") are deductible under either Code section 162(a) or 165(c)(1), and whether they are eligible for section 13141.

[a] Itemized Deductions and the Problem of "Voluntary" Repayments

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.

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[72] Treas. Reg. § 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").

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

[74] US Securities and Exchange Commission, Staff Compliance and Disclosure Interpretations Regulation S-K, Q&A No. 117.03 [Aug. 14, 2009].

[i] Retroactivity and the Unreasonable Compensation Cases

The first question is whether a repayment is "voluntary" if made pursuant to 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. These involve compensation repaid pursuant to an agreement between an officer-shareholder and the employer/corporation of which he is a shareholder, when the agreement stated that compensation would be repaid if the IRS later determined that the compensation was nondeductible because excessive or "unreasonable" under section 162.[75] In all such instances, it was held that a deduction was available under section 162 for compensation first paid *after* the repayment agreement was in effect.[76] But a section 162 deduction was not available for repayments of amounts first paid *before* the repayment agreement was in effect, on the grounds that such repayments were voluntary.[77] The same constraint applies to business losses claimed under Code section 165(c)(1).[78]

Oddly, the concern for retroactivity arise on a when-paid basis, rather than a

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[75] Treas. Reg. § 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").

[76] *Oswald v Commissioner*, 49 T.C. 645 (1968) (repayment of part of officer-shareholder's salary for 1960 held deductible under I.R.C. § 162(a), where repayment required by corporation's 1952 bylaw requiring repayment of salary disallowed as a deduction). *Pahl v Commissioner*, 67 TC 286 (1976) (When officer-shareholder repays portions of salary earned over two years under agreement to repay amounts determined by IRS to be nondeductible; *held*, amounts *paid* after agreement entered into [even though earned before that date] are deductible under section 162(a)): Revenue Ruling 79-311 (when amounts advanced in earlier year repaid in later year to extent they exceed commissions earned pursuant to agreement in effect at time of original advance, *held*, repayments deductible under I.R.C. § 162(a)); Revenue Ruling 69-115, 1969-1 CB 50 (when amounts paid in earlier year repaid by employee in later year pursuant to agreement in effect at time of original payment to repay amounts determined by IRS to be nondeductible, *held*, repaid amounts deductible under section 162(a) ***even though*** "subsequent event" test barred section 1341 treatment (under section 1341(a) "appeared" test); 2001 IRS CCA Lexis 302 (June 15 2001) (when bonuses paid in earlier year repaid pursuant to settlement of civil litigation, held, repayment deductible by taxpayers under I.R.C. § 162(a)).

[77] *Blanton v Commissioner*, 46 TC 527 (1966) (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 v Commissioner*, 67 TC 286 (1976) (when officer-shareholder returns amounts pursuant to agreement to repay amounts determined to be nondeductible, *held*, amounts *paid* before agreement entered into are not deductible under section 162, 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 corporate lessor of which lessees are the sole shareholders, pursuant to agreement entered into after rental income initially paid, *held*, no deduction available either as loss, or as expense of carrying on trade or business, under 1939 Internal Revenue Code).

[78] *Simon v Commissioner*, 281 F.2d 520 (6th Cir 1960); *Pahl v Commissioner*, 67 TC 286 (1976).

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.[79]

[ii] 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/shareholders, in which the officer/shareholder agreed to return salary paid in a year to the extent the salary were determined by the IRS to be nondeductible under section 162. In many such cases, the facts involve what appears to be a bilateral agreement to return, rather than a unilaterally imposed payment obligation. More significantly, in *all* such 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.[80] By contrast, clawback policies are instituted unilaterally by the employer. The clawback is an unambiguous forfeiture, and not a recharacterization of investment returns.

[iii] 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 where repayment is the condition of receiving, say, future bonuses, a pay raise, or even continued employment. The IRS has long recognized that such repayments are not "voluntary" for section 165(c)(1) purposes. For example, Revenue Ruling 82-178 dealt with laid-off employees who, upon rehire, were entitled to be restored service credits and other employment rights, contingent on their repaying their formerly-received lump sum severance payment within 60 days of rehire. The ruling held that, even though not mandatory, repayment

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[79] *Pahl v Commissioner*, 67 TC 286 (1976).

[80] *See, e.g., Berger v. Commissioner*, 37 TC 1026 (1962) 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, e.g., United States v Simon*, 281 F. 2d 520 (6th Cir 1960), 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.

of the severance was a deductible under section 165(c)(1) as a loss incurred in employee's trade or business, because required as a condition of restoring other benefits.[81] Rev. Rul. 79-322 involved a Federal employee who in one year received sick pay, and in a later year repaid it, when repayment was a condition for receiving certain workers-compensation type benefits. It was held that amounts paid to repurchase sick leave pay were a business loss deduction under section 165(c)(1).[82]

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, unfortunately, they are not bullet-proof. One confounding factor is that the repayment policy in these rulings 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."[83]

[iv] Bottom Line: Retroactive Clawbacks are Likely Deductible Under Section 162 or 165

In short, while the matter is not free from doubt, the likely answer that retroactive clawbacks are deductible by the employee under section 162 or 165. The better to 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).

[v] Retroactive Clawbacks and Section 1341

Section 1C.03[2][e] discussed the issues raised by applying section 1341 to retroactive clawbacks. We here very briefly recapitulate that discussion. The IRS's current touchstone for section 1341 still seems to be the confused and confusing apparent-right test. Under this test, section 1341 might not apply to a retroactive clawback. This is because the taxpayer had an 'actual" right to the payment when received, a right defeased only by a subsequent clawback policy retroactively applied.

The IRS has indicated that a second argument might deny section 1341 treatment to repayments made under a retroactively imposed payment condition, namely, the

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[81] Rev. Rul. 82-178, 1982-2 CB 59.

[82] Rev. Rul. 79-322, 1979-2 CB 76.

[83] Additional confusion arises from the fact that the two involuntary-repayment rulings are conceptually indistinguishable from the no-personal-liability rulings discussed above, where 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 setoff 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.

argument that such repayments are "voluntary." The statutory source of this "voluntary" argument is section 1342(a)(2)[84] Some early case law, too, analyzed such repayments as "voluntary," thereby barring section 1341 treatment by application of section 1342(a)(2).[85] The concept of involuntariness as a touchstone for section 1341, however, has led to a practical and conceptual dead end. It is not clear, for example, whether the definition of "voluntary" for section 1341 purposes is the same or different from that used for section 162 and 165(c)(1) purposes. Early cases used the term as interchangeable and identical for all three sections.[86] By contrast, however, other cases have held, that payments deductible under section 162 or 165(c)(1) may nonetheless be too "voluntary" to warrant section 1341. A rich source of such confusion—with differing outcomes among cases with seeming similar facts—are the many cases involving settlements in anticipation of litigation.[87] In any event, possibly because of

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[84] Section 1342(a)(2) requires that it be "determined" after the close of the taxable year that the taxpayer "did not have" an unrestricted right to the payment. See, e.g., TAM 9516002; CCA 200808019. 2001 IRS CCA Lexis 304; Revenue Ruling 58-456. 1958-2 CB 415.

[85] *Blanton v Commissioner*, 46 TC 527 (1966) (when officer/shareholder repays salary determined by IRS to be nondeductible, pursuant to agreement with employer entered into after salary paid, held, voluntary repayments are not deductible under section 162(a) or section 1341 because repayment fails I.R.C. § 1342(a)(2)); *Pahl v Commissioner*, 67 TC 286 (1976) (similar to *Blanton*—when officer/shareholder repays salary determined by IRS to be nondeductible, pursuant to agreement with employer entered into after salary paid, held, amounts not deductible under code section 162, 165 or 1341); *Berger v. Commissioner*, 37 TC 1026 (1962) (when salary repaid to employer pursuant to agreement, entered into after salary paid, that amounts repaid if determined by IRS to be nondeductible, held, deduction not available under section 1341(a)(2) when repayment is voluntary. For the repayment to be other than voluntary, payee must have at least the "ability to legally compel" the repayments); *Barrett v Commissioner* 96 TC 713 (1341 not available unless taxpayer under legal obligation to repay); *Kappel v United States*, 437 F2d 1222 (3d Cir 1971 (similar)); *Adams v Commissioner*, 58 T.C. 41 (1972) (final judgment not required, but section 1341 available only if repayment arises from determination that claim against taxpayer would be resolved adversely to taxpayer); *Pike v Commissioner*, 44 T.C. 787 (1965), *acq.* 1968-2 C.B. 2.

[86] *Blanton v Commissioner*, 46 TC 527 (1966) (voluntary repayments nondeductible under I.R.C. §§ 162 and 1341); *Pahl v Commissioner*, 67 TC 286 (1976) (voluntary repayments nondeductible under sections 162, 165 and 1341); *But see Pike v Commissioner*, 44 T.C. 787 (1965), *acq.* 1968-2 C.B. 2 (when profits repaid in response to administrative investigation, *held*, repayment not eligible for section 1341, because taxpayer could not prove validity of claims against him, even though repayment is deductible as "ordinary and necessary" business expense under I.R.C. § 162).

[87] *Compare Pike v Commissioner*, 44 T.C. 787 (1965), *acq.* 1968-2 C.B. 2 (when profits repaid in response to administrative investigation, *held*, repayment not eligible for section 1341, because taxpayer could not prove validity of claims against him); *Adams v Commissioner*, 58 T.C. 41 (1972) (while final judgment not required, section 1341 available only for repayment arising from determination that claim against taxpayer would be resolved adversely to taxpayer) *with, e.g.*, CCA 200808019 (in case involving disgorgement of insider trading profits under 16(b), I.R.C. § 1342(a)(2) does not require that repayment obligation be established by final judgment); Revenue Ruling 58-456, 1958-2 CB 415) (I.R.C.

the concept's lack of utility, recent IRS authorities appear to avoid use of the voluntary-versus involuntary distinction in section 1341 analysis.

As discussed above, the case law (and some IRS guidance) has apparently abandoned the concept entirely in favor of the more fruitful "same circumstances" test. Under the same-circumstances test, section 1341 should be available for retroactive clawbacks. Return to our example of the employee whose 2010 performance bonus is clawed back in 2012 because 2010 earnings are restated in that year, and further assume that the clawback policy was first created in 2012. For example, if a bonus granted for stated earnings targets being satisfied, and the bonus is clawed back because earnings for that year are restated. Section 1341 should apply, because, even though retroactively applied, the clawback arises from the same terms and conditions (failure of earnings target) as the original payment (assumed satisfaction of earnings target.

As also noted in the above discussion, the IRS has in at least two revenue rulings applied the same circumstances test rather than the apparent-right test to repayments, either implicitly (Revenue Ruling 72-28) or expressly (Revenue Ruling 2004-17).

[4] 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 compete, a covenant of confidentiality or, more broadly, a covenant to refrain from activity detrimental to the former employer. If the executive fails to observe these covenants, the bonus may be clawed back under the agreement.

[a] Employee's Deductions

Generally, a payment made by an employees or former employee as "liquidated damages" for breach of an employment contract is deductible under section 165(c)(1).[88] Accordingly, bad boy clawbacks should generally be deductible. The availability of Section 1341 raises more complicated issues, which were set forth at length in Section A and are briefly summarized here. As there noted, the IRS has

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§ 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 not return bonuses absent litigation); *Barrett v Commissioner*, 96 TC 713 (section 1341 applies only to compensation repaid under legal obligation to repay, but requirement is met for amounts returned pursuant to settlement agreement).

[88] See, e.g., Rev. Rul. 67-48, supra (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 I.R.C. § 165(c)(1)); GCM 39336 (February 5, 1985).

expressly held that section 1341 does not apply to a clawback triggered by a contract breach. Its rationale is the apparent-right test, under which section 1341 is not available when the taxpayer's actual right to payment is defeased by a subsequent event. As also described above, however, the same circumstances test of case law and some IRS revenue Rulings, would allow generally section 1341 relief in this case.

[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 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 not available for the repayment.[89] While no authority exists on point, it is conceivable that this "claim of wrong" doctrine could deny section 1341 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 this case? The answer is not clear, and will depend on the facts. The threshold for wrongdoing here is high, and does not appear to apply short of conviction for or admission of criminal wrongdoing.[90] 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 where criminal wrongdoing is not implicated.

[5] Retirees and Other Former Employees: Special Issues

Numerous potential issues are raised by clawbacks from former employees. One of them involves section 409A, but because section 409A issues can affect current as well as former employees as well, this topic is discussed separately at subsection [6].

[a] Anticutback Clauses

Unlike qualified retirement plans, nonqualified pension plans are not governed by a statutory prohibition against amendments reducing benefits accrued under the plan. Many nonqualified retirement plans, however, have similar anti-cutback clauses as a

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[89] Rev. Rul. 68-153, 1968-1 C.B. 371, (holding proceeds from embezzlement activity later repaid, the embezzler not permitted a refund calculated pursuant to I.R.C. § 1341). *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978) *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989).

[90] *Compare Barrett v. Commissioner*, 96 T.C. 713 (1991) (When amounts returned pursuant to settlement of criminal charges where taxpayer did not concede criminal wrongdoing, held I.R.C. § 1341(a)(1) does not bar availability of I.R.C. § 1341), *nonacq.* AOD CC 1992-008 (March 23 1992) *with Parks v. United States*, 96-2 USTC (CCH) (W.D. Penn. 1996) (disagrees with *Barrett*); see CCA 200808019—(claim of wrong does not bar 1341 when section 16(b) requires disgorgement of profits, since disgorgement is absolute obligation, without regard to wrongdoing).

matter of contract. Many SERPs, for example, prohibit any amendment that reduces benefits without the consent of the participant. Before implementing a set-off against a nonqualified retirement plan benefit, it is thus necessary to check the plan document for limitations of this kind.

[b] Itemized Deductions and Former Employees

The primary tax 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.[91] Former employees can claim a section 162 deduction for outplacement services to the same extent, and under the same limitations, they could claim a section 162 deduction if still employed.[92]

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 ever be so totally severed from the labor force that 162 or 165(c)(1) deduction is unavailable.

Under IRS guidance, the answer seems to be that even a completely retired

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[91] *Biehl v. Commissioner*, 118 TC 467, 477–8 (2002) (Attorney's fees paid by former employee in wrongful termination suit are deductible "below the line" under section 162, because incurred in his trade or business of being an employee), *aff'd* 351 F3d 982 (9th Cir 2003); *Cites McKay v. Commissioner*, 102 T.C. 465, 489 (1994) (held, 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); *Alexander v. Commissioner*, T.C. Memo. 1995-51 (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).

[92] Rev. Rul. 92-69, 1992-2 CB 51 (holding that threshold condition of seeking section 132 exclusion for outplacement services is ability to claim deduction for expense as 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 expenses relating to seeking employment in the same line of work).

employee can deduct repayments of compensation under section 165(c)(1). For example, the IRS has held 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).[93] Similarly, a former employee who was required to pay liquidated damages for breach of contract was allowed to deduct the repayments under section 165(c)(1).[94] In neither ruling is it stated that the former employee has potential 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 former employer under section 165(c)(1).

[c] 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 held that the retiree can in addition claim section 1341 treatment if the repayment exceeds $3,000.[95]

[6] Section 409A and Set-offs from Nonqualified Deferred Compensation

When clawbacks are enforced via set-offs from other compensation, an issue may arise if the compensation subject to reduction is nonqualified deferred compensation under section 409A. This could happen if the clawback were deducted from SERP benefits, parachute payments or other post-severance amounts. But it could also happen in the active employee context. Consider, for example, a performance-based restricted stock unit (RSU) clawed back by reducing a subsequent RSU payable in the clawback year, when the RSU payable in the clawback year is subject to 409A.

In this case, a potential issue arises under the sweeping substitution rule of the 409A regulations. The substitution rule states that any payment made as a "substitution" for a payment of nonqualified deferred compensation is deemed to be payment of that deferred compensation.[96] Under the deemed-payment rule, a substitution payment paid at a different time than initially scheduled for the original payment could violate section 409A as a prohibited acceleration (if paid earlier) or a prohibited subsequent deferral (if paid later).

The substitution rule is potentially implicated when a clawback is set-off from

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[93] Revenue Ruling 2002-84, situation 3.

[94] Revenue Ruling 67-48, 1967-1CB 50 (when amount paid by taxpayer as liquidated damages for breach of contract to former employer, deductible as business loss under section 165(c)(1) in year paid).

[95] *Id.*

[96] Treas. Reg. § 1.409A-3(f).

nonqualified deferred compensation. For example, consider an executive who is terminated with a $500,000 parachute payable in 2012 subject to section 409A. Assume further that in 2010 he received a $100,000 performance bonus, which is clawed back in 2012 by being deducted from his parachute. Accordingly, his net parachute paid in 2012 is $400,000.

Concern is raised because of the exception to the substitution rule set forth by Treas. Reg. § 1.409A-3(j)(4)(xiii). This provision states that a plan may provide for the acceleration of payment, as "satisfaction of a debt of the service provider to the service recipient," up $5,000 (for all years), if the reduction is made "at the same time and in the same amount as the otherwise would have been due and collected from the service provider." Does this mean that the set-off in our example is a prohibited acceleration because it is a reduction in excess of $5,000 "in satisfaction of a debt of the service provider to the service recipient"?

The correct answer should be no. Moreover, it is easy to structure the set-off safely to avoid running afoul of section 409A.

Assume in this example that in compliance with Revenue Ruling 79-311, the employer reports the gross $500,000 parachute on the executive's W-2 filed for 2012 (even though the executive received a net payment of only $400,000). By including the $100,000 set-off in gross income, as consistent with Revenue Ruling 79-311, the employer in this example has avoided potential violation of the substitution rule. For section 409A purposes, the entire $500,000 is paid as scheduled, with no acceleration. This is because or section 409A purposes, "payment" is defined as inclusion in income.[97] Even assuming that the deducted $100,000 is a substitution for a portion of the parachute otherwise payable, it is not a prohibited substitution because it does not change the timing of the payment. The entire $500,000 is paid, as scheduled, in 2012.

A note of caution here. The example assumes that the $100,000 setoff is deducted from the $500,000 parachute and included in gross income at the same time that the entire parachute would otherwise be payable. If this is not the case, then there may be a prohibited timing shift in violation of section 409A.

Alternative approach: excluding hold-back from gross income. We have said that when clawbacks are set-off from nonqualified deferred compensation, section 409A can safely be satisfied by reporting the set-off in taxable gross income in compliance with revenue Ruling 79-311. Change the above example, so that, rather than complying with Revenue Ruling 79-311, the employer instead reports the parachute on the employee's 2012 W-2 as the $400,00 amount net of the clawback (in violation of PLR 9103031 but in compliance with Revenue Ruling *2002-84*).

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[97] 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).

Does the employer's alternative reporting 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 set-off is a violation of the $5,000 limit under Treas. Reg. § 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 taxable amount received under a claim of right.

Nonetheless, under the excessively broad reach of the substitution rule of 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 reported in compliance with Revenue Ruling 79-311, included the gross amount of such nonqualified deferred compensation reported on the employee's W-2 or Form 1099.

[7] Repaying Employer Stock and Other Property—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 affects of appreciation, assume that the stock is transferred when its fair market value (FMV) 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 pursuant to 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.[98] 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).[99]

Now assume that the shares are clawed back after declining in value to FMV of $80.

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

[99] Treas. Reg. § 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).

The employee is still allowed an ordinary loss deduction equal to basis,[100] 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 the shares restored ($80) rather than their FVM included in income at the time of vesting ($100).[101]

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 grant, when the shares' FMV is $90. In this 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 share are still "substantially nonvested," regulations give him a deduction for the amount paid.[102] The loss, however, may be taken only as a capital loss, rather than an ordinary loss.[103] If the property has substantially vested, the deduction for the payment amount is apparently not available.

[8] 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, provided that the refund is claimed not 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 later-arising events.[104]

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[100] I.R.C. § 165(b)(1).

[101] Treas. Reg. § 1.1341-1(d)(2)(i) (exclusion allowed for "amount restored in the taxable year").

[102] Treas. Reg. § 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 TC 184 (2006), aff'd 534 F.3d 1197 (9th Cir. 2008), *Guzak v. US*, 75 Fed. C. 304 (2007).

[103] Treas. Reg. § 1.83-2(a) ("If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss").

[104] *See, e.g.*, Revenue Ruling 79 311 (when advances paid to employees exceed earned commission-

In our example, the employer must reimburse the Employee share of the FICA tax withheld from the original bonuses.[105] Reimbursement is effected by deducting the refunded FICA payments against the employee's share of FICA taxes otherwise withheld from wages paid in the in the repayment year, or is made directly to the employee if the employee's FICA taxes in the repayment year are less than the refunded FICA taxes.[106] The employer reports the overpayment of both employee's and employer's share of FICA taxes on an amended return (Form 941-X) for the period, and generally, receive an adjustment by taking a credit against the payment of employment tax liabilities for the return period in which the adjusted return is filed.[107] The employer must complete all these actions before the statute of limitations for filing a FICA refund claim has expired,[108] that is, not later than three years after the filing date of the original Form 941.[109] (By contrast, refunds of income tax withheld from wages may not be claimed after the calendar year in which the wages are paid).[110]

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 applies also to the employee's 2008 bonus, paid December 2008. The statute of limitations for FICA refunds has run with respect to the fourth quarter of 2008 by the date of the clawback in our example (July 2012). 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.

Repay the net or the gross? In order 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 (i.e., including the FICA taxes withheld) or whether the employee need only repay the amount net of FICA taxes withheld. Some IRS guidance suggests that repayment of the gross amount is required.[111] But in more recent guidance (dealing with returns of nonqualified

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ers, and are repaid at termination of employment pursuant to pre-existing contact agreement, *held*, in relevant part, taxpayer can claim credit for employee's share of FICA taxes withheld, under Treas. Reg. § 31.6413(a)-1(b)(i)).

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

[106] Treas. Reg. § 31.6413(a)-1(b)(2)(iii).

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

[108] *Id.*

[109] Treas. Reg. § 301.6511(a)-1(a)(1).

[110] Treas. Reg. § 31.6413(a)-1(b)(2)(i).

[111] SCA 1998029 (December 4, 1988) (providing that "*actual repayment* of wages by the employee

deferred compensation erroneously paid in violation of section 409A), the IRS has implied that return of the net amount is sufficient, provided that the employer has filed for refund under a properly filed Form 941-X.[112]

§ 1C.04 PRACTICAL CONCLUSIONS

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

(1) In the 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 W-2 net of the repayment amount. This is the case whether the repayment is tendered directly by the employee via check or cash, or deducted from other compensation payable during the year.

(2) More typically, clawbacks will require repayment of compensation first paid in a previous year. Tax treatment of the repayment is generally governed by Revenue Ruling 79-311. The repayment amount is included in the gross wages and income reported on the employee's W-2 for the repayment year. To mitigate the hardship of paying income taxes on amounts ultimately relinquished, the employee can deduct the repayment under Code section 162 (or 165(c)(1)), subject to the 2% floor and the AMT. Availability of section 1341 is not entirely free from doubt, because of the changing IRS position. By contrast, under the same-circumstances test adopted by the case law and a handful of IRS rulings, the employee can claim relief under section 1341, thus being made-whole for income taxes paid on the clawed-back amount. 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 deducted from (set off against) other compensation, rather than repaid directly, the authorities are somewhat confused. The safer approach is to follow Revenue Ruling 79-311 and include set-off in the gross income and

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to the employer through payroll deduction or otherwise must occur before an overpayment exists" (emphasis supplied). Further states that employer claims credits under Treas. Reg. §§ 31.6413(a)-1(b)(1) and 31.6413(a)-2 only "after" repayment).

[112] Notice 2008-113 § III.K generally requires that certain payments in violation of 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, § XIIA, clarifies that requirement satisfied if 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."

wages reported on the Form W-2 or 1099, subject to a deduction by the employee under section 162 or 165 if available, and section 1341 relief (if available). Alternatively, it is arguably permitted for the employer to net the set-off amount from the wages and income reported on the employee's form W-2 and 1099. The employer who adopts a netting approach rather than the Revenue Ruling 79-311 approach is subject to some risk of penalties for underwithholding should the IRS disagree with this position.

(4) Retroactive clawbacks—that is, repayments of amounts first paid before the clawback policy was adopted—are somewhat more problematic. While the matter is not entirely free from doubt, retroactive clawbacks should be deductible under section 162 or 165(c)(1). The better to 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 for retroactive clawbacks. Under the same-circumstances test of case law, however, section 1341 should be available for retroactive clawbacks.

(5) Bad boy clawbacks—clawbacks triggered by the employee's illegal unethical disloyal acts or other behavior subject to sanction—are deductible under section 165(c)(1). But, as in the case of retroactive clawbacks, application of section 1341 is less certain. Under the IRS's apparent right test, section 1341 is not available if repayment is required by a breach arising after the original payment. By contrast, the same-circumstances" test of case law and some IRS rulings, section 1341 should apply. If the circumstances of the clawback are so egregious as to implicate criminal conduct, it is possible the claim-of-wrong doctrine might preclude 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 from the labor force altogether, Former employees can also claim section 1341 treatment to the same extent as can current employees.

(7) Clawbacks enforced by being held back from nonqualified deferred compensation raise potential issues under the substitution rule of 409A regulations. These potential issues may be safely avoided by observing the IRS' prescribed tax treatment of set-offs under

Revenue Ruling 79-311. That is, the employer should report include the set-off in the gross nonqualified deferred compensation reported on the employee's W-2 or form 1099.

(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 upon 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 (specifically, 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 in some cases a deduction for any amount paid for the shares, taken as a capital loss.

(9) FICA taxes paid on the repaid amount—both the employer's and employee's share—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 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, most recent IRS guidance suggests that repayment *net* of the withheld FICA taxes is sufficient.