Deducting Pay Give-Backs

By Robert W. Wood • Wood & Porter • San Francisco

All the talk of pay give-backs may die down in the next few months. So far it appears that the proposal to tax certain bonuses at up to 90 percent will go nowhere in Congress. Yet the combination of government oversight and approbation on certain recipients of bonuses has been deafening. Since the various give-backs are not occurring under the same set of facts, and since we all know (or should know) that tax law doesn't always follow logic, this milieu has also prompted some to consider whether the tax benefits and financial consequences of a give-back will be in parity.

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When you are paid in one year, and give the money back the next year, just what is the tax treatment? One fundamental factual variable is whether the payment is made pursuant to government process (say a court or administrative order), a contract provision that might be interpreted to require repayment, pressure to "voluntarily" relinquish pay, *etc.* In some respects, a voluntary repayment is the most problematic from a tax viewpoint.

Apart from income tax, payroll taxes must also be considered. An executive who receives a $5 million bonus will have had payroll taxes taken out of the bonus before he receives his net check. If he turns around and gives the money back to the company, does he relinquish only his net payment? How the company and the IRS (plus the Social Security Administration and state tax authorities) make the payroll adjustment can be dicey. Sooner or later, both executives and companies are going to need to consider these tax issues.

Hobson's Choice

The choices for addressing these tax issues may involve business expense deductions under Code Sec. 162, amending prior year returns, salary and bonus offsets, and deductions under Code Sec. 1341. There is probably more confusion about Code Sec. 1341 than there is clarity, so this is a good place to start. Code Sec. 1341 embodies the claim of right doctrine, which basically means we must pay tax on something when we have a right to it.

Thus, we must include an item in income when we receive it and ostensibly have a right to it (with no obligation to give back). If it is later determined that our right to the money was not absolute and we must return it, that is a *separate* tax issue. If a taxpayer has had free and unfettered use of funds from the time of receipt, the tax year of receipt is the appropriate time to fix the tax liability. If you later have to give it back, Code Sec. 1341 attempts to place you back in the position you *would* have been in had you never received the income.

Frequently, other deductions are subject to limitations, phase-outs, floors and the AMT. To claim a deduction under Code Sec. 1341, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to it. Yet Code Sec. 1341 is not a deduction-granting section, so there must be an enabling deduction (usually Code Sec. 162 or 212).

Although the taxpayer must learn in a subsequent year that he did not actually have an unrestricted right to the item, the courts have generally interpreted this to mean that the taxpayer was compelled by law to repay the amounts. If a taxpayer meets the three tests of Code Sec. 1341, he can obtain the superior benefits of taking his deduction under Code Sec. 1341.

Amended Returns

Amending a prior year return might seem to be the cleanest method to effectuate a bonus repayment. Generally, however, taxpayers can amend returns only within three years of filing an original return, or within two years of the date the tax was paid, whichever is later. Plus, amending a prior year return is generally allowed only to correct a mistake.

Here, an amendment would not seek to correct a mistake, but would be changing the *nature* of the prior bonus transaction, netting it with the current repayment. Since the executive originally received the income under a claim of right and without restriction as to its disposition, the taxpayer probably cannot later amend his return.

Another alternative may be for the company to reduce the executive's current year salary or bonus. Yet this obviously can work only for *current* employees, and many repaying persons are *former* employees. Even for current employees, the sheer economics may not mesh. A whopping bonus may not be repeated. Plus, it isn't clear if an offset would achieve the same public relations or legal effect.

Pay It Back

A look at the case law suggests that compensation is rarely repaid. Most of the extant authorities involve closely held corporations and repayments by their controlling shareholders who are also either officers, directors or employees. Yet one of the seminal cases involves an officer who only owned approximately 25 percent of the corporation. That case was *G.L. Blanton*, 46 TC 527, Dec. 28,054 (1966), *aff'd per curium* CA-5, 67-2 USTC ¶9561, 379 F2d 558 (1967).

Mr. Blanton repaid his corporate employer the portion of his director's fees which the IRS determined to be excessive. He made the repayment pursuant to a contract (entered into after he received the fees, and possibly after the IRS deemed them to be excessive), which called for repayment of amounts the corporation could not deduct. According to the court in *Blanton*, it was irrelevant whether he was legally bound by the later contract to return the salary. It was also irrelevant whether Mr. Blanton and the corporation entered into the contract before or after the start of the IRS audit.

According to the court, the requisite lack of an unrestricted right to an item of income must arise out of the circumstances, terms and conditions of the original payment. It cannot arise from a subsequent agreement. The court disallowed a deduction under Code Sec. 1341, since the circumstances, terms and conditions surrounding the original payment indicated the taxpayer lacked an unrestricted right to such amount. Fortunately, later courts have eased up.

For example, in *E. Van Cleave*, CA-6, 83-2 USTC ¶9620, 718 F.2d 193 (1983), the board adopted a resolution in 1969 that payments to officers later disallowed by the IRS must be reimbursed by the officer. In addition to the bylaw change, the taxpayer entered into a separate contract with his controlled corporation requiring him to return his salary if the corporation could not deduct it. In 1974, Van Cleave received compensation which the IRS later deemed to be excessive. Upon demand from the board, Van Cleave returned the excess, and deducted the repayment under Code Sec. 1341. The trial court characterized Van Cleave's return of his salary as "voluntary," since he controlled the corporation.

The Sixth Circuit disagreed, allowing the deduction under Code Sec. 1341. The appellate court held that the fact a restriction on a taxpayer's right to income does not arise until a year subsequent to receipt does not affect the availability of Code Sec. 1341. The court did not say whether the bylaw requirement to return the salary, and the similar contract provisions were equally compelling.

Clearly, contract give-back provisions are becoming more common in executive compensation agreements. It may not be necessary for the repayment to be made pursuant to a judgment to be characterized as involuntary. The payment must be made under circumstances entitling someone to enforce the demand for payment by legal action in the absence of compliance. [*See* Rev. Rul. 58-456, 1958-2 CB 415.]

Miscellaneous Itemized

These days, the phrase "miscellaneous itemized" sounds like stale leftovers—not very appealing. For many workers, a pay give-back may generate a miscellaneous itemized deduction, subject to the two-percent of adjusted gross income floor. Since such deductions are below-the-line, they face phase out and AMT. An executive who foregoes (or ignores) Code Sec. 1341 may find this unattractive.

To be deductible, an expense must generally be ordinary, necessary and a business expense. The regulations acknowledge that services performed as an employee can constitute a trade or business. [Reg. §1.162-17.] To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. But determining whether an expense is necessary is far less clear.

The key is whether the payment was voluntarily made or legally required. A pre-existing legal obligation to return money may be enough. For example, in *V.E. Oswald*, 49 TC 645, Dec. 28,879 (1968), the taxpayer's controlled corporation included in its original bylaws a requirement that any compensation not deductible by the corporation must be repaid. Later, when the taxpayer repaid the corporation the nondeductible amount, the court allowed the taxpayer's deduction. Since the corporation's bylaws were enforceable, repayment was necessary.

In contrast, in *J.G. Pahl*, 67 TC 286, Dec. 34,109 (1976), the taxpayer's controlled corporation paid him an excessive salary. The bylaws did not provide for repayment of nondeductible compensation, but the board later amended the bylaws to so provide. Although the board made the amendment prior to being audited, the amendment was made in the middle of a tax year which was later audited. The court denied the taxpayer's deduction for salary paid prior to the amendment, but allowed a deduction for salary repaid *after* the amendment.

Payments prior to the bylaw amendment were deemed voluntary. Bear in mind that almost all of this case law deals with controlled privately-held corporations, where the majority shareholder was a director, officer or employee—in some cases, all three. There don't seem to be any cases in which the repaying director, officer or employee was not a significant shareholder.

FICA Fix?

Wages are subject to withholding, and pay give-backs need to address that too. FICA has two components: old-age, survivors and disability insurance (OASDI) and hospital insurance. Generally speaking, both employer and employee pay 6.2 percent of wages in OASDI, but only up to the maximum wage base (which for 2008 was $102,000 and for 2009 is $106,800). While both employer and employee pay hospital insurance of 1.45 percent of an employee's wages, there is no maximum wage base, so liability is unlimited.

If a bonus is repaid within the three-year statute of limitations, the company must presumably repay the executive for the employment tax overpayment or reduce his future employment tax withholding. [*See* Reg. §31.6413(a)-1(b)(1).] The company could then claim credit (on a subsequent employment tax filing) for overpaying its portion and the employee's portion. If the statute of limitations has expired, the company is presumably not required to repay an executive the overpaid employment tax, and the company could evidently not claim a credit for any overpaid employment tax.

Cause Celebre

Pay give-backs are occurring in settlements of lawsuits, early stage investigations and in response to public reproval. In the latter, issues of the voluntary versus mandatory character of the repayment are especially likely to arise. Although public outrage and litigation sound more ominous than the prospect of losing a tax deduction for returning compensation, the tax cost to this kind of mismatch is hardly trifling.

In fact, tax woes may add enormously to the executive's overall cost of a payback. To escape the voluntariness conundrum, what if all bonus hoarders asked for a written demand from their employer "requiring" the payback? Perhaps only altruistic (and tax sensitive) payees will voluntarily ask for a repayment demand. If anyone needed proof tax law was formulaic, this could be it.