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Deducting McGuire's $620 Million Forfeiture

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On December 7, 2007, *The Wall Street Journal* heralded former UnitedHealth Group CEO William McGuire's forfeiture of $620 million, calling it one of the largest executive pay givebacks in history.[1] McGuire was ousted in 2006 over a stock option backdating scandal. According to reports, McGuire is hardly destitute, retaining approximately 24 million stock options, the exercise of which would result in a gain of roughly $800 million. That comes on top of approximately $530 million in pay McGuire pocketed while running UnitedHealth from 1991 to 2006.[2]

The forfeiture — in some ways voluntary, in some ways not — settled two related civil cases. One was with a special committee of the company's board of directors that was assigned to probe shareholder claims over backdating. McGuire agreed to surrender stock options, retirement benefits, and other funds totaling $420 million. (He had already agreed to surrender $200 million when he was ousted in 2006; thus, the total of $620 million.)

The outsize payment also helped settle a separate Securities and Exchange Commission complaint that had included a $7 million civil penalty. That civil penalty is also a record setter: the largest to date against an individual in a backdating case. McGuire neither admitted nor denied wrongdoing, but the SEC settlement bars him from serving as an officer or director of a public company for 10 years. Interestingly, a criminal inquiry is still pending in the Manhattan U.S. Attorney's office, although it is not clear whether that will continue.

The form of the giveback is also interesting. McGuire will reportedly surrender to UnitedHealth about 9.2 million stock options that the company values at about $320 million. These options are unexercised, so their tax treatment should be easy for both him and the company.

[1]*See* Fuhrmans and Bandler, "Ex-CEO Agrees to Give Back $620 Million," *The Wall Street Journal*, Dec. 7, 2007, p. A1.

[2]*Id.*

Assuming McGuire still hasn't exercised those options, he hasn't taken them into income and the company hasn't claimed a deduction, so unwinding this should presumably be no big deal. McGuire will also give up his right to $91 million in a retirement plan and surrender another $8 million in an executive savings account — again, nothing too interesting from a tax perspective.

Regular old cash compensation (salary or bonus) givebacks is where things get interesting. And, although the former UnitedHealth CEO's giveback may be the most newsworthy recent repayment, there are suggestions that repayments of cash, options, and other compensation are becoming more commonplace.

UnitedHealth alone has indicated it has "clawed back" about $900 million from former and current executives.[3] The methods and legal maneuverings for these clawbacks vary. For example, under section 304 of the Sarbanes-Oxley Act, executives can be required to forfeit bonuses or other incentive compensation. If a public company has to reissue financial statements as a result of misconduct, the CEO and CFO may have to reimburse the company for any bonus or other incentive-type compensation and for any profits made from the sale of the company's stock within the previous year.

Oddly, there is no enforcement mechanism in the statute, nor does it define misconduct. It does not even make clear whether it applies to *former* CEOs and CFOs or only current ones. If a CEO is caught with his hand in the till, the CEO will probably be a former CEO when it comes time for a restatement that may trigger a repayment obligation. That timing raises issues about just how mandatory a repayment may be.

Voluntary Payback

Whatever the factual setting, a voluntary repayment of cash compensation raises interesting and fundamental tax questions. For example, does the Internal Revenue Code allow the undoing of a prior transaction? If so, how does this square with the axiom of annual accounting, one of the underpinnings of our tax system? If one tries to undo a completed transaction by giving back compensation, can one be made whole via a tax deduction? If a deduction is warranted, what is the timing and character of the payment?

Suppose a disgraced executive received a $20 million cash bonus in 2006, on which state and federal income taxes have been withheld, along with Social Security and other payroll taxes. Suppose the executive has to give it back in 2008. Does he just give back his net check after all those deductions?

Not hardly, although a savvy disgraced executive might well try to negotiate for that kind of payment. If a

[3]*Id.*

court or administrative order directs the repayment, or even if a contract provision is triggered to do so, the true payment to the executive was $20 million (actually, the payment was even more than that when you consider the employer's portion of payroll taxes). The taxes withheld are credited to the executive's income tax obligations and Social Security account, and it may be his problem to get them back. The company may offset tax amounts, but is probably not obligated to.

The easiest settings to address are those in which the cash bonus and the cash giveback both occur in the same year. However, that seems rare. That means the repaying executive, whether he must return the entire bonus or only some net number after deductions, has a tax problem: He has previously included in income (and probably as wages) an amount he is now returning and wants to deduct.

Deducting Repayment

Several possibilities suggest themselves. It may be possible for the payer to claim a deduction under section 1341 for restoring an amount held under claim of right. The claim of right doctrine requires a taxpayer to pay tax on an item of income in the year in which he received it under a claim of right, even if it is later determined that his right to the item was not absolute and he is required to return it.[4] This rule is based on the proposition that if a taxpayer has 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. This is but one manifestation of the annual accounting principle on which our tax system is based.

The claim of right doctrine allows the taxpayer to deduct a repayment from his income in the year of repayment (as opposed to deducting the amount in a prior year). This result was mandated by the Supreme Court, because income and deductions are determined on an annual basis.[5] Of course, annual accounting often results in a mismatch. The taxpayer may benefit less from the deduction in the year of repayment than he would benefit if he had been able to deduct the amount repaid in the year of receipt. This may occur, for example, when the taxpayer was in a higher tax bracket in the year of receipt than in the year of repayment.

Section 1341 is not simple. Under it, a taxpayer who has previously reported income under a claim of right may be able to deduct the repayment in a subsequent year (but only if the amount restored is greater than $3,000). A section 1341 deduction usually provides a better result than a deduction under other code sections, since it attempts to place the taxpayer back in the position he would have been in had he never received the income. Frequently, other deductions can be subject to limitations, phaseouts, floors, and so on.

Not So Fast

Taxpayers must meet some requirements to claim a deduction under section 1341. First, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to the item. Does UnitedHealth's McGuire meet this first requirement? Presumably yes. At the time his bonuses were awarded and paid, he probably had no knowledge or belief he might have to return them.

Second, a deduction must be allowed under another code section. Section 1341 is not a deduction-granting section.[6] As discussed in more detail below, McGuire could be allowed a deduction under section 162 as an ordinary and necessary business expense, so he appears to meet this requirement too.

A third requirement for a deduction under section 1341 is that the taxpayer must learn in a subsequent year that he did not actually have an unrestricted right to the item. Courts have frequently interpreted this to mean that taxpayers were compelled by law to repay the amounts. In other words, the taxpayer's repayment must be involuntary.

There is a dearth of authority on arrangements of this sort. Although McGuire settled his case, presumably he could prove he was compelled to return his $620 million. His tax position would be clearer if he had actually been ordered to pay back money. However, while legal compulsion seems an absolute standard, a settlement, with execution of legal releases, presumably operates in the same way as a judgment.

If a taxpayer meets the three tests of section 1341 and therefore qualifies for the deduction, he can obtain the superior benefits of taking his deduction under section 1341, compared with the inferior deduction he would receive under the underlying code section (let's say section 162) on which the section 1341 deduction is based. For McGuire, all other things being equal, it would probably be better to use section 1341 than section 162.

The explanation for the superiority of section 1341 is that a non-section-1341 deduction in the year of repayment often will not reduce the taxpayer's tax liability by the amount paid as a result of the initial inclusion. For example, if the taxpayer's tax rates are lower in the year of repayment than in the year of inclusion, the taxpayer would not derive a benefit from the deduction equivalent to the tax burden in the year of receipt. Part of section 1341's superiority stems from its providing the taxpayer the greater benefit of either (1) deducting the repayment in the year of repayment or (2) reducing his tax liability by taking a credit (in the year of repayment) for the amount of tax he could have avoided if he had excluded the item from income in the year of inclusion.

Furthermore, unlike an ordinary and necessary business expense the executive might claim under section 162, the deduction provided by section 1341 is not a miscellaneous itemized deduction. Section 1341 can actually make a taxpayer whole, effectively as if the prior transaction hadn't occurred.

For example, in Rev. Rul. 58-456,[7] a corporation distributed excess mortgage payments to its shareholders, violating its corporate charter. Under threat of legal action, the shareholders later repaid the dividend and

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

[5] *United States v. Skelly Oil Co.*, 394 U.S. 678, 681 (1969).

[6] *Id.*

[7] 1958-2 C.B. 415.

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were able to restore their basis in their stock to the extent the prior distribution affected their basis. Suppose the taxpayer had a basis of $1,000 in his stock and received a distribution of $10,000 when the corporation had no earnings and profits. The first $1,000 would constitute a return of basis and the remaining $9,000 would constitute income.

If later the taxpayer were required to repay the entire $10,000, only $9,000 could qualify as a deduction under section 1341, and the remaining $1,000 would constitute a restoration of the basis of the stock.

Setting Precedent

There is little authority regarding the application of the claim of right doctrine to repayments of compensation. Perhaps that's because, historically, compensation is rarely repaid. Most of the extant authority involves closely held private corporations and repayments by controlling shareholders who are also either officers, directors, or employees. While McGuire may try to distinguish this authority, a brief review of this authority helps pinpoint what courts and the IRS consider important.

Closely held corporations were involved in most of the case law in this area. Nevertheless, one of the seminal cases involves an officer who owned only about 25 percent of the corporation. In *George Blanton*,[8] the taxpayer repaid to his corporate employer a portion of his director's fees the IRS had determined to be excessive. The IRS denied the corporation a deduction for the excessive portion of his fees.

The taxpayer made the repayment under a contract (entered into after he received the fees, and possibly after the IRS deemed them to be excessive) that called for the repayment of amounts the corporation could not deduct. This kind of savings clause is often triggered by golden parachute payments — the executive has to give back the portion of any payment that triggers the double whammy of nondeductibility and the excise tax on excess parachute payments. However, savings clauses are cropping up in other contract provisions too.

According to the court in *Blanton*, for purposes of obtaining a deduction by restoring amounts held under a claim of right, it was irrelevant whether the taxpayer was legally bound by the later contract to return the salary. Furthermore, it was irrelevant whether the taxpayer and the corporation entered into the contract before or after the start of the IRS audit. Under the claim of right doctrine, 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.

Thus, the court disallowed a deduction under section 1341, since the circumstances, terms, and conditions surrounding the original payment did not reflect the fact that the taxpayer lacked an unrestricted right to that amount. Later courts have softened the rigid stance that the repayment must come from the circumstances, terms, and conditions surrounding the original payment. Indeed, a deduction for restoring an amount held under claim of right may be possible if, before the IRS disallows the corporate deduction, the corporation's board enacts a resolution requiring repayment if the corporation cannot deduct it and the taxpayer executes an agreement to do the same.

In *Van Cleeves*,[9] 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 that he would return his salary if the corporation could not deduct it. In 1974 Van Cleeves received compensation that the IRS later deemed to be excessive, so the corporation could not deduct a portion of it.

On demand from the board of directors, Van Cleeves returned the portion of his salary the corporation could not deduct. On his own tax return, Van Cleeves deducted the repayment under section 1341. Since he was in a higher tax bracket in the year of repayment, the use of section 1341 (versus section 162) had more than an immaterial effect.

The IRS contested the application of section 1341, and the trial court agreed, characterizing Van Cleeves's return of his salary as ''voluntary.'' Since he controlled the corporation, the power to compel repayment was entirely in his hands. The court saw no sound policy in allowing the deduction, since there would be no downside to a taxpayer who received an excessive salary if there was a preexisting requirement to repay the nondeductible portion. Nevertheless, the Sixth Circuit disagreed, allowing the taxpayer's deduction under section 1341.

The appellate court held that the fact a restriction on a taxpayer's right to income does not arise until a year after that of receipt does not affect the availability of a section 1341 tax adjustment. The court expressly noted that Congress designed section 1341 to alleviate this problem. A deduction from another code section (aside from section 1341) may leave the taxpayer less than whole, and section 1341 is supposed to remedy that.

Interestingly, the court did not comment on whether the requirement imposed by the bylaws to return the salary and the similar requirement in the contract between the corporation and the officer were equally compelling. Was one alone sufficient, and if so, which one? The court didn't say. Careful practice may suggest that we should provide for repayment both in organizational documents (such as bylaws) and in employment and consulting contracts.

Out of Luck?

As we've seen, the road to a deduction under section 1341 has some navigational quirks. The requirement that the repayment must be involuntary may be easy with a court or administrative order, or perhaps even in a bitterly negotiated settlement. But there are many possibilities under which a repayment may be advisable. Even

[8] *George Blanton v. Commissioner*, 46 T.C. 527 (1966), *aff'd per curiam*, 379 F.2d 558 (5th Cir. 1967).

[9] *Van Cleeves v. United States*, 718 F.2d 193 (6th Cir. 1983).

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aside from lawsuits, contract giveback provisions are becoming common in executive compensation agreements.

In any case, the focus on a legal mandate does suggest an ironic result. A fired executive could obtain a deduction under the claim of right doctrine if he loses a legal battle and has to pay. Yet, a more altruistic executive — who gives back the money because it's the right thing to do — could not. Such perversions invoke Dickens's admonition that ''the law is a ass, a idiot.''[10]

Of course, it may not be necessary for the repayment to be made under a judgment to be characterized as involuntary.[11] However, the payment must be made under circumstances entitling someone to enforce the demand for payment by legal action in the absence of compliance. In Rev. Rul. 58-456, the preferred shareholder (who was the Commissioner of the Federal Housing Administration) could, under the corporation's charter, enforce the return of a dividend on the common stock. Thus, five years after the dividend, on demand by the preferred shareholder, the common shareholders returned the dividend and were able to deduct the payment under section 1341.

Second Best

Let's suppose there is no compulsory repayment. In lieu of obtaining a deduction for restoring amounts previously received under a claim of right, the next best thing would be an ordinary and necessary business expense deduction under section 162. Compared with a deduction under section 1341, section 162 provides only a current-year deduction and does not necessarily make the taxpayer whole. Also, section 162 provides only a miscellaneous itemized deduction, subject to the 2 percent adjusted gross income floor. Since deductions under section 162 are below the line, the deduction is subject to phaseout and the taxpayer may also face alternative minimum tax issues.

While section 162 has nuances, to be deductible an expense must generally be (1) ordinary, (2) necessary, and (3) a business expense. The requirement that the bonus repayment be a business expense seems easy. Although there is no statutory or regulatory definition of what constitutes a business expense for an executive, the regulations acknowledge that services performed as an employee can constitute a trade or business.[12] Many courts have come to the rescue of corporate officers, ruling that their services also constitute a trade or business.

The bonus repayment should also be considered ordinary. The determination whether an expense is ordinary depends on the facts and circumstances of a particular taxpayer. Indeed, the Supreme Court noted more than 70 years ago that whether an expense is ordinary is determined by its time, place, and circumstance.[13] Generally speaking, an expense is ordinary if a business would commonly incur it in the particular circumstances involved.

To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. A once-in-a-lifetime piece of litigation does not fail to be ''ordinary'' just because it is unusual, unexpected, or unlikely to reoccur. If a company is suing a former executive for fraudulent financial statement manipulation, it would seem that a one-time payment by other executives to bring prior bonuses in line with restated financial statements should be an ordinary expense.

Determining whether an expense is necessary is far less clear. The key to the necessary determination is whether the payment was voluntarily made or legally required.[14] A voluntary repayment of compensation in a later tax year does not allow the taxpayer to take a section 162 deduction. In *Blanton*,[15] the IRS audited the taxpayer in 1963 regarding salary received in 1959 through 1961. The court determined that while Blanton had a contract to repay any portion of his salary that was not allowed as a deduction to the corporation, his repayment contract was entered into no earlier than 1962.

In rejecting Blanton's section 162 deduction, the court said there was nothing in the record to establish that the repayment rendered the taxpayer any business benefit or was in any sense ordinary and necessary to his position at the company. Unfortunately, the court's opinion regarding the section 162 deduction is contained in precisely one sentence (unlike its lucid section 1341 discussion noted above). Over time, other courts have expanded on *Blanton's* laconic analysis.

Although it was unclear what the effect of a retroactive repayment contract was under *Blanton*, in *United States v. Simon*,[16] on substantially similar facts, the taxpayer made his contract with his controlled corporation retroactive. Not surprisingly, the court did not find this additional fact convincing, since the agreement was still entered into after the year in which the original salary had been paid. Indeed, the court found no business purpose, only tax advantages, in the retroactive nature of the contract. When an executive gives back compensation, there should surely be some business purpose, not a tax incentive.

The situation is markedly different when a preexisting legal obligation requires the taxpayer to return the money. For example, in *Oswald v. Commissioner*,[17] 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 section 162 deduction. Since the corporation's bylaws were enforceable, repayment was necessary.

In rejecting the IRS's argument, the court noted that the repayment bylaw served a valid business purpose —

[10]*Oliver Twist*, Chapter 51, p. 489.
[11]*See* Rev. Rul. 58-456, 1958-2 C.B. 415.
[12]Reg. section 1.162-17.
[13]*Welch v. Helvering*, 290 U.S. 111 (1933).
[14]*See* Rev. Rul. 69-115, 1969-1 C.B. 50.
[15]*Supra* note 8.
[16]281 F.2d 520 (6th Cir. 1960).
[17]49 T.C. 645 (1968).

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to help the company pay its increased tax bill caused by the denial of the compensation deduction. The purpose of the repayment bylaw was not to provide the taxpayer a deduction. A deduction, if allowed, reduces the taxpayer's tax.

Yet, no one would argue that the taxpayer would be better off financially if he did not have to repay the corporation. The rationale of the courts in this line of cases becomes even clearer in *Pahl v. Commissioner*.[18] In *Pahl*, the taxpayer's controlled corporation paid the taxpayer an excessive salary. The original bylaws did not provide for repayment of nondeductible compensation, but the board later amended the bylaws to so provide.

Although the board enacted the amendment before being audited, the amendment was made in the middle of a tax year that was later audited. Not surprisingly, the court denied the taxpayer's deduction for salary paid before the amendment, but allowed a deduction for salary repaid after the amendment. Payments before the bylaw amendment were deemed voluntary.

In the brouhaha over public company compensation, just how pertinent these cases are is debatable. Almost all of this case law deals with controlled, privately held corporations in which the majority shareholder was either a director, officer, or employee — in some cases, all three. There don't seem to be any cases in which the director, officer, or employee was not a significant or majority shareholder. In this closely held context, a latent issue is whether the excessive compensation is really a disguised dividend.

Employment Taxes

Repayment of a bonus on which an executive (and the company) has already paid employment taxes makes it possible that the executive and company end up paying extra employment taxes.[19] FICA has two components: Old Age, Survivors, and Disability Insurance and hospital insurance. Generally, both the employer and the employee pay 6.2 percent of an employee's wages in OASDI, but only up to the maximum wage base, which for 2008 is $102,000. Neither employers nor employees pay OASDI on wages in excess of the maximum wage base. While both an employer and employee pay the hospital insurance at 1.45 percent of an employee's wages, there is no maximum wage base. Thus, a $20 million bonus incurs the hospital insurance tax.

If after a bonus repayment, an executive's prior year salary is less than the $102,000 OASDI maximum wage base, the executive would have overpaid both OASDI and the hospital insurance. In the more likely scenario in which the executive's postrepayment wages exceed the OASDI maximum wage base, the executive would not have overpaid any OASDI, but would have overpaid hospital insurance tax. It is possible for an executive to be made whole regarding the overpayment of prior year's employment tax.

For example, if a bonus is repaid within the statute of limitations, the company must either repay the executive for the employment tax overpayment or reduce his future employment tax withholding.[20] The company would then be able to claim a credit on a subsequent employment tax filing for overpayment of both its portion and the employee's portion of the prior overpayment. If the statute of limitations has expired, however, it would seem that the company would not be required to repay an executive the overpaid employment tax.

Also, the company could evidently not claim a credit for any overpaid employment tax. In this scenario, the executive would apparently get stuck with paying employment tax on the returned bonus. His only recourse may be to hope for the company's compassion and sense of fair play.

Amending Prior-Year Returns

Amending a prior-year return might seem to be the cleanest method to effectuate a bonus repayment, and perhaps to entirely avoid the issues surrounding a later deduction. Generally, however, taxpayers can amend returns only within three years of the date of filing the original return, or within two years of the date the tax was paid, whichever is later.

Yet, the IRS generally will not allow taxpayers to amend returns under repayment circumstances such as these.[21] Amending a prior-year return is generally allowed only to correct a mistake on the return. Here, an amendment would not seek to correct a mistake. Rather, it would be changing the *nature* of the prior bonus transaction by netting it with the current repayment transaction.

Netting across several tax years goes against our tax system's root annual accounting concept. It also goes to the heart of the claim of right doctrine. Since the executive originally received the income under a claim of right, and without restriction as to its disposition, the taxpayer cannot later amend his original return.

Salary Reduction?

Another potential method to effectuate a repayment may be for the company to reduce the executive's current-year salary. Of course, this works only for current employees, and many repaying persons, like McGuire, are now *former* executives. Plus, it isn't clear if an executive's giveback would achieve the same public relations coup (or the same legal effect) if he agrees to an offsetting salary reduction, even though simple math suggests that he has, in fact, paid the money back.

As with amending a prior-year return, this method may appear to avoid some of the sticky issues associated with repayment. There does not appear to be any direct authority disallowing this arrangement, although it does seem to circumvent much of the above discussion. The IRS might argue that in fact two transactions (a current salary and a repayment of a prior year's salary) are being

[18]67 T.C. 286 (1976).

[19]*See* SCA 1998026, *Doc 98-36964, 98 TNT 250-46,* and Rev. Rul. 79-311, 1979-2 C.B. 25.

[20]Reg. section 31.6413(a)-1(b)(1).

[21]*See Lewis*, 340 U.S. 590 (1951).

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netted, and each must be reported separately.[22] However, it isn't yet clear how this particular possibility for handling executive paybacks will play out.

Conclusion

The pressures of public opprobrium and litigation are probably far more frightening than the prospect of losing a tax deduction for having to return compensation. Still, the tax cost of this kind of mismatch adds enormously to the executive's overall cost of the payback. And it's always interesting when the tax treatment of something seems out of whack with its economics.

Indeed, on a fundamental level, this is the kind of tax issue that one can imagine an otherwise sophisticated client not understanding at all. The headaches an executive would face on having to not only give back, say, $20 million, but to then find he's been tax disadvantaged too, will be palpable. Whatever the tax result, we may see more pay givebacks, not only in settlements of lawsuits, but perhaps also in more early-stage investigations, where issues of the voluntary versus mandatory character of the repayment are likely to arise.

[22]*See* SCA 1998026, *supra* note 19, and Rev. Rul. 79-311, *supra* note 19.

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