Boomerang Bonuses: Tax Effects When You Get It But Give It Back

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The dot-com bust and the post-dot-com economic slump have each generated a good deal of finger pointing. In the resulting era of corporate scrutiny, several investor lawsuits have been launched against former (and lingering) blue-chip companies. Yet, massive lawsuits, together with the headlines that precede and follow them, hardly seem to raise eyebrows. Similarly, while shareholder derivative suits abound, their occurrence today seems almost commonplace.

Last but not least are the lawsuits brought against that once seemingly unassailable American icon: the chief executive officer. Civil and criminal cases against CEOs may be the most spirited of all those cases. And why not? There is a tawdry quality to much of this. Who can resist learning where to purchase a $20,000 shower curtain? Or learning how a multimillion dollar birthday party on Sardinia for the CEO's wife can be justified as a business expense? That is the stuff of tabloid journalism, grist for the businessman's version of *The Jerry Springer Show*.

The list of fallen icons seems to be continually updated, growing ever longer. Earlier this year, Bernie Ebbers, former CEO of WorldCom, was found guilty for his part in concealing an $11 billion accounting fraud. His explanation: He just didn't know. Adelphia is another story that reads like a Greek tragedy, with Rigas family members' faults unfolding faster than highflying Icarus's wings melted in the sun. More recently, ousted AIG Chief Maurice ''Hank'' Greenberg has found himself in the crosshairs.

Congress passed the Sarbanes-Oxley Act of 2002[1] in response to the explosion of corporate malfeasance — or at least the explosion in awareness that this behavior kept popping up even in the best families. Sarbox, as the law is sometimes known, was tantamount to the government shaking its fists and scowling at white-collar miscreants. Indeed, Sarbanes-Oxley may be opening a new can of liability worms for corporate wrongdoers, some of which may have unexpected tax consequences.

Under section 304 of the Sarbanes-Oxley Act, executives may now be required to forfeit bonuses or other incentive compensation. Generally speaking, if a public company has to reissue financial statements as a result of misconduct, the CEO and chief financial officer 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 prior year. Notably, CEOs and CFOs don't need to be the reason for the restatement.

While the purpose of section 304 may be laudable, it seems unlikely to be frequently enforced. In fact, there is no enforcement mechanism included in the statute. Also, Sarbox does not define misconduct, nor does it make it clear whether it applies to *former* CEOs and CFOs. If the CEO is caught with his hand in the till, it seems unlikely that the board is going to wait around to determine if Sarbanes-Oxley will come to the rescue. In all likelihood, the CEO will be a former CEO when it comes time for a restatement that may trigger the repayment obligation.

Pay It Forward

In an unusual development, however, some Nortel Networks executives (but, notably, not the CEO or CFO) may voluntarily do what Congress couldn't find a way to require: Repay huge bonuses that were awarded based on financial statements now being restated.

On January 11, 2005, Nortel, a giant telecom company, released restated financial statements for 2001 through 2003, noting that some executives had manipulated the results to obtain bonuses. In February Nortel filed suit against three former executives who may have been responsible for the manipulation, seeking to recover $10.5 million in prior bonus payments. Nortel, however, said other executives, who are still with the company and who also received bonuses based on the original financial statements but were not implicated with the manipulation, would voluntarily repay $8.6 million of cash bonuses over the next three years and give back certain restricted stock, which had also been previously provided as a bonus.[2]

Nortel is a Canadian corporation publicly traded on both the Toronto and New York Stock Exchanges. While its headquarters are located in Ontario, Nortel maintains a substantial presence in the United States. Even though Nortel is a Canadian corporation, it is subject to the Sarbanes-Oxley Act because it is listed on the New York Stock Exchange.[3]

The voluntary repayment of cash bonuses raises some interesting and fundamental tax questions. For example, does the code allow the undoing of a prior transaction? If so, how does that square with the axiom of annual accounting? If not, can the executives be made whole via a deduction? If a deduction is warranted, what would be the timing and character of the payment?

Make Me Whole

It may be possible to make the executives whole if they are able to claim a deduction under section 1341 for restoring an amount held under claim of right. To understand how section 1341 operates, however, we need to

[1] P.L. 107-204 (2002).

[2] *See* Anne Newman, ''Giving Back the Bonus,'' *Business Week*, Jan. 24, 2005, p. 46.

[3] For purposes of this article, we assume the Nortel executives who are giving back their bonuses are residents of the United States for tax purposes.

take a brief detour into the claim-of-right doctrine. Essentially, Congress enacted section 1341 to alleviate the inherent unfairness of the claim-of-right doctrine.

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 that he is required to return it.[4] The rule is based on the proposition that because the taxpayer has the free and unfettered use of funds from the time of receipt, the tax year in which that receipt occurs is the appropriate time to fix the tax liability. Essentially, that is a manifestation of the annual accounting principle on which our tax system is based.

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

Under section 1341, a taxpayer who previously reported income under a claim of right may be able to later deduct the repayment in a later 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 because 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 forth.

Not So Fast

Taxpayers must meet certain requirements to obtain a deduction under section 1341, which the Nortel executives might not meet. First, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to the item. The executives might meet the first requirement because, when the bonuses were awarded and paid, they likely had no knowledge or belief that they might have to return them.

Second, a deduction must be allowed under another code section. As noted by the Supreme Court, section 1341 is not a deduction-granting section.[6] As discussed below, the Nortel executives may be allowed a deduction under section 162 as an ordinary and necessary business expense.

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 often interpreted that to mean that taxpayers were compelled by law to repay the amounts. In other words, the taxpayer's repayment must be involuntary.

The Nortel executives may have trouble proving that they were compelled to return the bonuses. Their tax position would be improved if they had been named as defendants in the suit and ordered to pay back the bonuses rather than deciding to voluntarily pay them back. Perhaps an imminent threat that they would be added as defendants prompted the seemingly voluntary giveback, but it's unclear how strong the nexus must be. Legal compulsion, after all, seems an absolute standard.

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 to 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 the Nortel executives, all other things being equal, it would be better to use section 1341 than section 162. The explanation for section 1341's superiority 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 burden imposed by inclusion in the year of receipt.

Part of section 1341's superiority stems from its providing the taxpayer the greater benefit of either deducting the repayment in the year of repayment or 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. Further, unlike an ordinary and necessary business expense the executive might obtain under section 162, the deduction provided by section 1341 is not a miscellaneous itemized deduction.

Not only does section 1341 make a taxpayer whole regarding taxes paid, but it also can make a taxpayer whole as if the prior transaction hadn't occurred at all. 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 were able to restore their basis in their stock to the extent that the prior distribution affected their basis. Suppose the taxpayer had a basis in his stock of $1,000 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 the taxpayer were later 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.

[4] *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).
[5] *U.S. v. Skelly Oil Co.*, 394 U.S. 678, 681 (1969).
[6] *Skelly Oil*, 394 U.S. 678.
[7] 1958-2 C.B. 415.

Where's the Beef?

There is little authority regarding the application of the claim-of-right doctrine to repayments of compensation, perhaps because compensation is not often 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 the Nortel executives would likely try to distinguish that authority, a brief review of it helps pinpoint what courts and the IRS consider to be important.

Although closely held corporations comprise most of the case law in this area, one of the seminal cases involves a corporate officer who owned only about 25 percent of the corporation. In *George Blanton*,[8] the taxpayer repaid his corporate employer a portion of his director's fees that 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 for which the corporation could not obtain a deduction. That kind of savings clause, incidentally, is often triggered by golden parachute payments, so 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.

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. Further, 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. As such, the court disallowed a deduction under section 1341 because 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 somewhat 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 obtain a deduction and the taxpayer executes an agreement with his employer to do the same.[9]

In *Van Cleave*, the board adopted a resolution in 1969 that payments to officers that are disallowed by the IRS would be reimbursable by the officer. In addition to the bylaw change, the taxpayer entered into a separate contract with his controlled corporation under which he would return his salary if the corporation could not deduct it. In 1974 Van Cleave received compensation that the IRS later deemed excessive such that the corporation could not deduct a portion of it. On demand from the board of directors, Van Cleave returned the portion of his salary that the corporation could not deduct. On his tax return, Van Cleave claimed the repayment fell under section 1341. The utilization 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 with the Service. The trial court characterized Van Cleeves's return of his salary as voluntary. Because he controlled the corporation, the power to enforce and compel the repayment was entirely in his hands. The court saw no sound policy in allowing the deduction, because there would be no downside to a taxpayer who received an excessive salary if there was a preexisting requirement to repay the nondeductible portion.

The Sixth Circuit disagreed and allowed the taxpayer's deduction under section 1341. The court held that the fact that a restriction on a taxpayer's right to income does not arise until a year after the time of receipt does not affect the availability of a section 1341 tax adjustment. The court expressly noted that Congress designed section 1341 to alleviate that exact problem, because a deduction under another code section (aside from section 1341) may leave the taxpayer less than whole. Interestingly, the court did not comment on whether the requirements to return the salary imposed by the bylaws and by the contract between the corporation and the officer were equally compelling, if one alone were sufficient (and which one), or if one of the two were irrelevant. Thus, careful practice suggests providing 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, including the requirement that the repayment must be involuntary. Unfortunately, the Nortel executives' bonus repayment may ultimately be characterized as voluntary. Perhaps the Nortel bylaws might provide some relief, or more likely still, perhaps there's a contract between Nortel and the executives requiring repayment of bonuses when the underlying financial statement on which the bonuses were calculated has been restated. On the latter point, perhaps that provision might become standard language in executive compensation agreements. After all, golden parachute payment savings clauses have become common. Assuming there are no such provisions to mandate the return of the money, and if, as news reports suggest, their return of the money is truly voluntary, I'm guessing that the Nortel executives could not use section 1341.

Of course, a judgment requiring repayment would perhaps be the paradigm of an involuntary payment. The executives could obtain a deduction under section 1341 if Nortel obtained a judgment against them requiring them to return the bonuses. In a case that predates section 1341 but is a foundational element in claim-of-right jurisprudence, a taxpayer was allowed a deduction under the claim of right doctrine for repayment of an erroneously computed bonus after his employer won a judgment

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

[9]*Van Cleave v. U.S.*, 718 F.2d 193 (6th Cir. 1983).

against him.[10] Given that Nortel hasn't yet sought a judgment against the executives, there may be a timing problem. And perhaps a confession of judgment (or consensual judgment) wouldn't be considered sufficiently mandatory.

In any case, the focus on a legal mandate suggests an ironic result. The fired Nortel executives could obtain a deduction under the claim-of-right doctrine if they lose a legal battle against Nortel and have to pay. However, a more altruistic executive who gives back the money because it's the right thing to do could not. Those perversions invoke Dickens's admonition that the law is "an ass, an idiot."[11]

Of course, it may not be necessary for the repayment to be made under a judgment to be characterized as involuntary.[12] 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. Therefore, 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 for the Nortel executives would be an ordinary and necessary business expense deduction under section 162. As compared with section 1341, section 162 provides only a current-year deduction and does not necessarily make the taxpayer whole. Section 162 provides only a miscellaneous itemized deduction, subject to the 2 percent adjusted gross income floor. Because deductions under section 162 are below the line, the deduction is subject to phaseout and the taxpayer may also face the alternative minimum tax.

Of course, it is axiomatic that section 162 provides a deduction for ordinary and necessary business expenses. While section 162 has almost infinite nuances, generally, to be deductible, an expense must be ordinary, necessary, and a business expense. Meeting two of those requirements may be fairly straightforward, but the Nortel executives might have trouble meeting all three.

The Nortel executives should have no trouble meeting the requirement that the bonus repayment is a business expense. 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.[13] Numerous courts have come to the rescue of corporate officers, providing 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. The Supreme Court noted over 70 years ago that whether an expense is ordinary is determined by its time, place, and circumstance.[14] 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. In a situation in which Nortel is suing some of its former executives 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 would be an ordinary expense.

The determination whether an expense would be considered necessary is far less clear. The key to the necessary determination is whether the payment made was voluntarily made or legally required.[15] A voluntary repayment of compensation in a subsequent tax year does not allow the taxpayer to take a section 162 deduction. In *Blanton*,[16] the IRS audited the taxpayer in 1963 regarding salary received in 1959 through 1961. While Blanton had a contract to repay any portion of his salary that was not allowed as a deduction to the corporation, the court determined that 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 affirmatively 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). As practitioners, we are left in the dark as to the implication of the court's holding.

Over time, other courts have expanded on *Blanton's* laconic analysis. It was unclear under *Blanton* what the effect would be of making his contract to repay the excessive salary retroactive. However, in *U.S. v. Simon*,[17] on facts similar to *Blanton*, the taxpayer had in fact made his contract with his controlled corporation retroactive. Not surprisingly, the court did not find that additional fact convincing, because the agreement was still entered into after the year in which the original salary had been paid.

Indeed, the court noted that there was no business purpose, only tax advantages, in providing that the contract be retroactive. Of course, that analysis may not

[10] *U.S. v. Lewis*, 340 U.S. 590 (1951).
[11] *Oliver Twist*, ch. 51, p. 489.
[12] *See* Rev. Rul. 58-456, 1958-2 C.B. 415.
[13] Treas. reg. section 1.162-17.
[14] *Welch v. Helvering*, 290 U.S. 111 (1933).
[15] *See* Rev. Rul. 69-115, 1969-1 C.B. 50.
[16] *Supra* note 8.
[17] 281 F.2d 520 (6th Cir. 1960).

be dispositive to the case of our Nortel friends. There, it would seem that primarily a business purpose, and not a tax incentive, would exist, not to mention a strong public policy incentive, for allowing a retroactive contract so that the Nortel executives could take a deduction on the repayment of their recalculated bonus.

The situation is markedly different when a preexisting legal obligation requires the taxpayer to return the money. For example, in *Oswald v. Commissioner*,[18] 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 amount that was not deductible, the court found that the taxpayer could take a section 162 deduction, because the corporation's bylaws were enforceable, and repayment was necessary.

In rejecting the IRS's argument, the court noted that the bylaw calling for repayment served a valid business purpose, which was 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. It is unclear whether that point was overlooked by prior courts or whether this court was moved by the fact that this was a corporate bylaw and not just an employment contract.

The rationale of the courts in this line of cases becomes even clearer in *Pahl v. Commissioner*.[19] In *Pahl*, the taxpayer's controlled corporation paid the taxpayer an excessive salary. The corporation's original bylaws did not provide for repayment of compensation if the IRS denied a deduction, but the board of directors later amended the bylaws to so provide. Although the board enacted the amendment before being audited, the enactment occurred 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 paid after the amendment, because payments before the amendment were deemed to be voluntary.

Against those authorities, the Nortel executives may not be able to secure a deduction under section 162. However, just how pertinent those cases are is debatable. Almost all of that case law deals with controlled privately held corporations in which the majority shareholder was either a director, officer, or employee (or in some cases, all three). There don't seem to be any cases in which the director, officer, or employee was not at least a significant, if not majority, shareholder.

Those cases are different from one in which a major public company has affected executives who are neither board members nor controlling, or even significant, shareholders. In the prior cases, a significant latent issue, albeit one frequently not discussed in the cases, is whether the excessive compensation is really a disguised dividend. Because the Nortel executives are not significant shareholders, perhaps they should be evaluated differently.

The executives are not repaying the bonuses on an IRS finding that the corporation could not obtain a tax deduction. The IRS has not determined — and probably would not determine — that the bonus payments to the executives were excessive. The executives are repaying their bonuses on their own. Tax motivation is not the driving force behind the repayment.

Indeed, some might argue that the executives have a moral obligation to return the bonus. Others may argue that an implied job security issue exists (which may provide a good business purpose for a section 162 deduction). Yet others may believe the repayment is completely altruistic.

Employment Taxes

A word about employment taxes. Repayment of a bonus on which the executives (and the company) have already paid employment taxes makes it possible that the executives and the company may end up paying employment taxes on income the executives don't ultimately retain.[20] FICA has two components: old-age, survivors, and disability insurance and the hospital insurance. Generally speaking, 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 2005 is $90,000. 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, no maximum wage base exists.

Thus, if after the bonus repayment an executive's prior-year salary were less than the $90,000 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 still have overpaid the hospital insurance. Because there is no maximum wage base for the hospital insurance — no matter how large (or small) the recalculated wages end up being — the executive will always have overpaid at least some employment tax.

It is possible that the executives can be made whole regarding the overpayment of a prior year's employment tax. If the bonus is repaid within the statute of limitations, Nortel must either repay the executives for the employment tax overpayment or reduce their future employment tax withholding.[21] Nortel 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 Nortel would not be required to repay the executives the overpaid employment tax. Also, Nortel could evidently not claim a credit for any overpaid

[18]49 T.C. 645 (1968).
[19]67 T.C. 286 (1976).

[20]*See* SCA 1998026 and Rev. Rul. 79-311, 1979-2 C.B. 25.
[21]Treas. reg. section 31.6413(a)-1(b)(1).

employment tax. In that all-too-likely scenario, the executives would apparently get stuck with paying employment tax on the returned bonus, and their only recourse would be to hope for Nortel's compassion and sense of fair play to make them whole.

Amending Prior-Year Returns

Readers may wonder why this article has yet to mention the possibility of the Nortel executives amending their prior-year returns. At first glance, amending a prior-year return would appear to be the cleanest method to effectuate the repayment and perhaps entirely avoid the issues surrounding a later deduction. Generally speaking, 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. Although that limitation may stress the ability of the Nortel executives to amend prior-year returns, because they plan to repay bonuses received in 2001-2003 over the next three years, the IRS generally will not allow taxpayers to amend their returns under repayment circumstances such as those.[22] Again, the annual accounting albatross gets in the way.

Also, amending a prior-year return is generally allowed only to correct a mistake on that return. Here an amendment would not be seeking to correct a mistake. Instead, 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 annual accounting concept and goes to the heart of the claim-of-right doctrine. Because the executives originally received the income under a claim of right and without restriction as to its disposition, the taxpayers cannot later amend their original returns.

Salary Reduction

Another potential method to effectuate the repayment would be for Nortel to reduce the executives' current year salary. Therefore, if an executive's 2005 salary is $300,000 and he plans to repay $200,000 each year over the next three years, Nortel could reduce his salary to $100,000 in 2005. Of course, that method would require that the executive's current salary be greater than the annual payback. Plus, it isn't clear if the executive would achieve the same public relations coup (or the same legal effect) from the payback if he agrees to the offsetting current salary reduction, even though simple math suggests that he has, in fact, paid the money back.

As with amending a prior-year return, at first glance that method appears to avoid some of the sticky issues associated with the repayment. There does not appear to be any direct authority disallowing that arrangement, although it does seem to circumvent much of the above discussion. Undoubtedly, the IRS would likely argue that in fact two transactions (a current salary and a repayment of a prior year's salary) are being netted, and each must be reported separately.[23]

Conclusion

No one ever said tax law was simple. If any of the Nortel executives should happen to read this article, perhaps they'll think twice about returning the bonus. The executives do not appear to have certainty of obtaining a deduction for restoration of amounts held under a claim of right under section 1341, or for an ordinary and necessary business expense deduction under section 162. In fact, the limited authority that exists seems to point toward no deduction.

Of course, the pressures of public opprobrium and litigation are probably far more imminent and far more frightening than the prospect of losing a tax deduction down the road. Still, the tax cost to that 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.

Nevertheless, the Nortel executives would have arguments for allowing a tax deduction, and the prior authority may be distinguishable. Tax authority aside, it's uncertain whether outside of the Nortel executives any executives of a large public company have voluntarily repaid bonuses that were calculated based on the misdeeds of other executives. However, our current business climate makes one wonder if the Nortel executives' repayment will stand in isolation. Other executives at other public companies may follow Nortel.

It would be interesting to see how the IRS would approach that good deed. Sometimes a taxpayer who has performed a noble deed in truest Boy Scout fashion finds that the IRS returns the favor by giving him a pie in the face. Consider, for example, a lottery winner who, without seeking professional advice, contributes the entirety of his winnings to charity. All the winner gets is a tax bill (including a charitable contribution carryforward) and a warm smile from the charity.

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[22] *Supra* note 10.

[23] *Supra* note 20.