

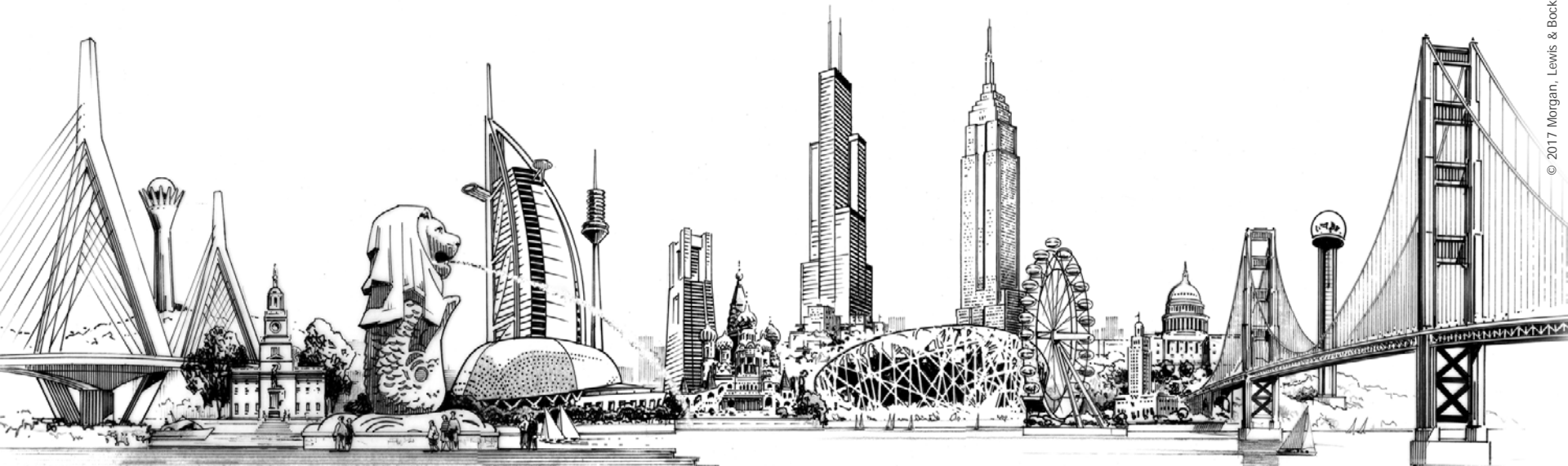
Morgan Lewis

COMPENSATION CLAWBACKS: TAX CONSEQUENCES FOR ISSUERS AND EXECUTIVES

Rosina B. Barker

Rosina.Barker@morganlewis.com

202.739.5210



What is a Clawback?

- Traditionally: Recoupment of compensation after it is earned for violation of company policy, agreement or law
- Sources of traditional clawbacks
 - Company policy or agreement (e.g., violation of non-compete)
 - Federal agency enforcement policy
 - Shareholder suits
- No-fault clawbacks under recent federal statutes
 - Sarbanes-Oxley Act of 2002 § 304
 - Emergency Economic Stabilization Act of 2008 § 111 (TARP Clawbacks)
 - Dodd-Frank Wall Street Reform and Consumer Protection Act § 954
 - Recovery of “erroneously awarded incentive-based compensation” if issuer is required to restate earnings due to “material noncompliance” with disclosure obligations of federal securities law. SEC Proposed Rule 10D-1.

The Future of Statutory No-Fault Clawbacks

- The Trump administration has signaled intent to repeal or amend Dodd-Frank, and could re-examine other financial regulatory regimes as well.
- But companies might voluntarily adopt no-fault clawback policies in connection with a financial restatement:
 - As part of the company's standard corporate governance practices.
 - Because not having a clawback policy is viewed negatively by proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis & Co. (Glass Lewis) .
 - Under an unjust enrichment theory.
 - For other reasons.

I. Company's Deduction

Deducting Bonuses: The General Rule

- Code Section 404(a)(5): Deferred compensation deductible in company's fiscal year in or with which ends employee's taxable year in which employee takes amount into income, rather than when accrued.

Generally:

- Compensation received more than 2 ½ months after company's taxable year of related services: deductible in year employee takes amount into income
- Compensation received within 2 ½ months after taxable year of related services: deductible in company's taxable year of accrual.
- Employee "receives" compensation for income tax purposes when paid or made available without substantial limitations or restrictions.
- Compare with proposed Rule 10D-1: Employee "receives" incentive-based compensation in employer's fiscal year in which financial reporting measure specified in compensation award is attained.
- For accrual basis taxpayer, deduction accrues when all events have occurred to fix fact and amount of liability.

Impact of Clawback Policy on Company Deduction

- Compensation subject to clawback is accrued under normal principles; clawback contingency is “remote” and should not defeat accrual. *See United States v. General Dynamics Corp.*, 481 U.S. 239 (1987).
- But if incentive based compensation is deducted in one taxable year of company, and recouped in subsequent taxable year, company might have to take amount back into income in year of recoupment, under the “tax benefit rule,” which generally requires income inclusion of amount previously deducted when events occur that are “fundamentally inconsistent” with the earlier deduction. *See, e.g., Larchfield Corp. v. United States*, 373 F.2d 159 (2d Cir.1966), Code section 111(a).

Example

- Company with fiscal year ended 12/31:
 - December 2013: grants RSU to Executive Officer, to be settled only if target financial reporting measure attained by end of three-year period ending 12/31/2016.
 - December 31, 2016: specified financial reporting measures met.
 - March 1, 2017: Company pays cash under RSU to Executive Officer, and accrues deduction for taxable year ended December 31, 2016.
 - In 2017, board concludes 2016 financial statements contain a material error rendering entire RSU settlement “erroneously awarded incentive-based compensation”.
 - In 2018, company files Form 8-K reporting restated financials.
 - In 2018, Executive Officer repays RSU settlement amount to company.
- Tax consequences to company
 - RSU is incentive based compensation “received” for Rule 10D-1 three-year lookback rule in company’s 2016 fiscal year.
 - RSU “received” by Executive Officer for tax purposes on March 1, 2017: Company accrues and deducts for its 2016 taxable year, reports on Executive Officer’s 2017 W-2.
 - Company takes 2016 RSU deduction into income in 2017 or 2018, depending on when it decides the “fundamentally inconsistent” event occurs.

II. Tax Withholding and Reporting for Employee

Repaying Compensation in the Same Year - Easy

- Bonus repaid in same year paid – for income and FICA tax purposes, treated as if never paid.
 - Principle of annual income tax accounting. *Couch v. Commissioner*, 1 B.T.A. 103 (1924), *acq.* 1925-1 C.B. 1 (1925), *Russel v. Commissioner*, 35 B.T.A. 602 (1937), *acq.* 1937-1 C.B. 22; Rev. Rul. 79-311, 1979-2 C.B. 25.
- EXAMPLE
 - Executive Officer is paid \$100K incentive-based bonus on March 30, 2018, based on 2017 financial reporting measures.
 - Bonus is “received” for tax purposes in employee’s 2018 taxable year, even though “received” for Rule 10D-1 purposes in company’s 2017 fiscal year.
 - Executive Officer repays \$100K to company on December 1, 2018.
 - Company does not report \$100K on Executive Officer’s 2018 W-2. Company can generally reverse any resulting over-withholding (for example, if employee repays by writing a check) by reducing withholding taxes from remaining compensation payable in 2018.

Repaying Compensation in Later Year – Hard

- EXAMPLE

- Executive Officer receives \$100K bonus in 2017, pays tax on 2017 Form 1040.
- Executive Officer repays \$100K bonus in 2018, by having amount withheld from compensation otherwise payable in 2018.
- 2018 reporting and withholding: IRS says Company may not report or withhold on employee's 2018 wages net of the 2018 \$100K bonus repayment Rev. Rul. 79-311, 1979-2 C.B. 25.
- Executive Officer can deduct \$100K on 2018 tax return under Code section 162 as miscellaneous itemized deduction.
- But miscellaneous itemized deduction is limited by 2% floor and is not available against alternative minimum tax (AMT).

Code Section 1341 Eliminates 2% Floor and AMT

- Section 1341 allows “make-whole” treatment of repaid amount.
- Taxpayer gets “better of” deduction or refundable credit:
 - Deduction for year of repayment (without 2% floor or AMT) or
 - Refundable credit equal to additional tax in year of payment
 - Both deduction and credit approach eliminate 2% floor and AMT
- Statute
 - Repayment over \$3,000.
 - Deductible under another Code section.
 - **It appeared** that taxpayer had **unrestricted right** to payment in year of payment.
 - Established after close of year that **taxpayer did not have right to payment.**

Impact of Section 1341: Example

- In 2017, employee receives \$400,000 performance-based bonus.
- Income tax on bonus = \$158,400 (= 39.6% x \$400,000).
- In 2018, entire bonus is clawed back upon accounting restatement.
Her 2018 AGI is \$1 million.
- Section 1341 relief entitles her to income tax refund of \$158,400.
- Absence of section 1341 relief:
 - She deducts \$380,000 (repayment in excess of 2% of \$1 million AGI).
 - Assume \$380,000 deduction is added in full to her Alternative Minimum Taxable Income (AMTI).
 - Assume AMT = \$106,400 (= 28% x \$380,000).
 - She recovers \$44,080 (= \$158,400 - (\$7,920 + \$106,400)) of \$158,400 income tax paid on bonus.
- She is \$114,320 worse off than had she not received the bonus.

Code Section 1341 – IRS Rulings Not Clear or Consistent

- Statute says Section 1341 available only if it “appeared” taxpayer had right to amount when received.
- IRS thinks “apparent” right means only illusory rights and not “actual” rights.
- Example: Executive Officer receives performance based compensation in Year 1, and repays it in Year 2 because accounting restatement shows it was “erroneously awarded” under Rule 10D-1. Can she claim Section 1341 relief?
 - **NO.** Her right to bonus was actual (non-illusory) under the original accounting statement “available” to her in Year 1. See Rev. Rul. 68-153 situation 2.
 - **YES.** Her right under the original accounting statement was illusory, as shown by accounting restatement. See Rev. Rul. 68-153, situation 3
 - **NO.** She had an actual (non-illusory) right under the original accounting statement. Her right was defeated by subsequent event, namely, the restatement and clawback policy. See Rev. Rul. 68-153, situation 4. The “subsequent event” analysis is arguably more likely to the extent board of directors has discretion on whether to enforce clawback. See, e.g., 80 FR 41144, 11163 (July 14, 2015).
- IRS rulings not always consistent and do not always follow “apparent but not actual right” test.

Code Section 1341 – Courts Reject IRS Apparent But Not Actual Right Test

- In *Dominion Resources*, 4th Circuit rejected IRS apparent-but-not-actual right test, applied “same circumstances” test. Tax Court, Court of Federal Claims, and the five Federal Courts of Appeal have adopted this test. None has adopted IRS position.
 - Section 1341 applies if original repayment payment made because of specified “circumstances, terms and conditions,” and repayment made because those “circumstances, terms and conditions” were not satisfied
- Can our hypothetical executive claim Section 1341 relief under this test?
 - Arguably **YES**. Bonus was paid because of specified circumstances, terms and conditions (original financial statement) and repaid because those circumstances, terms and conditions were not satisfied (financial restatement).
- Some IRS rulings follow the same-circumstances test: Rev. Rul. 72-78, 1972-1 CB 45; Rev. Rul. 2004-17, 2004-1 CB 51.

Section 1341 - The *Nacchio* Subjective Belief Test

- *Nacchio v. US*, United States Court of Federal Claims, March 12, 2014.
- Former CEO convicted of insider trading; disgorged \$45 million profit. In refund claim, sought \$18 million credit under section 1341 for income taxes paid on profits received but subsequently forfeited.
- Government argued section 1341 not available because taxpayer had no “apparent right” to gains based on trades jury found illegal.
 - Claims Court denied summary judgment. Whether taxpayer had apparent right under section 1341 depends on whether he “subjectively believed” he had right to funds, which is a question of fact. Criminal conviction via jury verdict not relevant to his subjective belief; taxpayer did not plead guilty.
- Appeals Court reversed on other grounds. Disgorgement was a “fine or similar penalty” barring tax deductibility under Code Sections 162 and 165.
- Did not touch subjective belief test: Was right apparent to taxpayer?

Repaying Compensation In Later Year: What About Netting Repayment Against Other Pay?

- Assume company recoups \$400,000 bonus by withholding it from \$1 million compensation otherwise payable in recoupment year.
- Can company report \$600,000 wages and income on W-2?
- Rev. Rul. 79-311, 1979-2 C.B. 25: **NO**
- There are some authorities for a YES position. *See, e.g., Aramony v. United Way*, 86 AFTR.2d 2000-5987 (S.D.N.Y. 2000).
- IRS might argue these are distinguishable.
- Good up-front paperwork will bolster company's arguments.
- **Company bears risk of interest and penalties for underwithheld taxes.**

Some Code Section 409A Issues

- In requiring repayments of nonqualified deferred compensation subject to Code Section 409A, keep in mind the basic Section 409A rules:
 - No accelerations (Code Sec. 409A(a)(3))
 - No subsequent deferral elections (outside of 12-month/5-year rule, Treas. Reg. Sec. 1.409A-2)
 - No substitutions (Treas. Reg. Sec. 1.409A-3(f))
- Repayment of compensation not yet paid and taken into income
 - Simplest solution: Clawback policy provides for forfeiture
 - Section 409A permits forfeiture if not accompanied by substitution of other amount payable at another time (Treas. Reg. Sec. 1.409A-3(f))
 - For Rule 10D-1 clawbacks, permissibility of repayment via forfeiture will depend on final SEC rule. *See generally* 80 Fed. Reg. 4114, 41163-4 (July 14, 2015)
- Repayment of compensation already paid and taken into income
 - Under Section 409A, issuer should be able to offset against compensation payable in later year, unless it reports and withholds on net basis in contravention of IRS position under Rev. Rul. 79-311. Netting could arguably raise Section 409A issues under no-substitution rule.

Recovering FICA taxes

- Claim of right doctrine does not apply to FICA taxes.
- Use procedures under Code section 6413 for erroneous overpayments.
- Employer recoups FICA taxes withheld by filing Form 941-X within statute of limitations (3 years after filing original Form 941).
- Employer must repay employee's share of withheld FICA taxes to employee, by reducing FICA taxes withheld from other wages, or directly.
- Also Employee must repay compensation to Employer.
 - Does employee have to repay gross payment, or payment net of FICA taxes already withheld?
 - Answer not entirely clear but recent IRS guidance suggests repayment of net amount is sufficient (but note that proposed Rule 10D-1 requires that Executive Officer repay entire pre-tax amount of erroneously awarded incentive-based compensation).

Biography



Rosina B. Barker counsels clients on the Employee Retirement Income Security Act (ERISA), tax, and securities law aspects of their employee benefits and executive compensation plans. Her practice ranges from sophisticated defined benefit pension plan matters to complex executive compensation issues. She regularly advises on compliance with Code Sections 409(A), 83, 162(m), 457A, and 280G; and frequently counsels on the benefits and executive compensation issues arising from mergers, divestitures, and other business reorganizations.

Rosina B. Barker

Washington

T +1.202.739.5210

F +1.202.739.3001

Rosina.barker@morganlewis.com

THANK YOU

© 2017 Morgan, Lewis & Bockius LLP

© 2017 Morgan Lewis Stamford LLC

© 2017 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Morgan Lewis

