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# Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation

Matthew A. Melone

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## ADDING INSULT TO INJURY: THE FEDERAL INCOME TAX CONSEQUENCES OF THE CLAWBACK OF EXECUTIVE COMPENSATION

*Matthew A. Melone*<sup>\*</sup>

I. Introduction .....	55
II. Compensation Clawbacks.....	59
A. In general .....	59
B. Federal Legislation .....	63
C. Contractual Clawback Provisions.....	69
III. Federal Income Tax Implications Of Compensation Clawbacks.....	75
A. Annual Accounting Principle.....	76
B. Claim of Right Doctrine .....	80
C. Taxation of Performance-Based Compensation .....	95
IV. Conclusion.....	120

### I. INTRODUCTION

Incentive-laden executive compensation arrangements have generated enormous paydays for many executives. The oft-staggering amounts awarded to many executives had their genesis in the rise of the celebrity chief executive officers in the aftermath of the leveraged buyouts that were common in the 1980s.<sup>1</sup> Tax law changes in 1993 and the reticence of accounting standard setters to mandate a full accounting of certain types of equity-based compensation contributed to the proliferation of equity-based incentive schemes with the potential for

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<sup>\*</sup> Professor of Law, Lehigh University Perella Dep't. of Finance, Bethlehem, PA.

1. See Daniel Altman, *How to Tie Pay to Goals, Instead of the Stock Price*, N.Y. TIMES, Sept. 8, 2002, at BU 4. Public opprobrium at outsized executive compensation has a long history. See Alan Brinkely, *Class Warfare: Railing Against the Rich: A Great American Tradition*, WALL ST. J., Feb. 7, 2009, at W1.

enormous payouts.<sup>2</sup> The accounting scandals that came to light in the early part of this decade, the most prominent of which were perpetrated by Enron and WorldCom, and the accompanying public outrage led to legislative reforms in 2002.<sup>3</sup> These reforms have done little to curb executive compensation. Executive compensation has continued to escalate, the gap between the top and average earners has continued to widen, and pay practices have retained their ability to both amaze and repulse the public.<sup>4</sup>

It is likely that had someone been told in 2006 that, within a few years, Merrill Lynch and Bear Stearns would no longer exist as independent entities; the two mortgage giants, Fannie Mae and Freddie Mac, would be placed into conservatorship; Lehman Brothers would file bankruptcy and liquidate; and that the federal governments would loan billions of dollars to auto companies, banks, and insurance companies, her reaction would have been either incredulity or sheer terror. The economic catastrophe that was 2008 has, at least up to this point, created a sea change in the attitudes toward executive compensation. The near collapse of the financial system and its effect on the broader economy

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2. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469-70 (1993) added section 162(m) to the Internal Revenue Code. This provision limits the deductibility of compensation paid by publicly traded corporations to the chief executive officer and the next four highest paid officers to \$1 million per executive. However, excepted from this restriction is performance-based compensation which includes cash bonuses based on performance metrics, stock options, and certain other forms of equity-based compensation. In addition, generally accepted accounting principles did not require, until very recently, an issuer of most compensatory stock options to record compensation expense as a result of such issuances. See Matthew A. Melone, *Are Compensatory Stock Options Worth Reforming?*, 38 GONZAGA L. REV. 535, 543-44, 554-58 (2003). See also *infra* note 250 and accompanying text.

3. See *infra* notes 31-32 and accompanying text.

4. Between 1947 and 1979 the top 0.1% of earners in the United States were paid approximately twenty times as much as the average of the bottom 90% of earners. By 2006 the 20:1 ratio had grown to 77:1. *More or Less Equal?*, *Special Report on the Rich*, ECONOMIST, April 4, 2009, at 11. According to a *Wall Street Journal* analysis of Social Security Administration data, approximately one-third of all earnings in 2007 were earned by highly compensated employees—those whose wages exceeded the old age, survivor, and disability payroll tax base. The *Wall Street Journal*'s analysis actually understates the percentage of income that flowed to highly compensated employees because the data did not include the value of incentive stock options, unexercised nonqualified stock options, and unvested restricted stock. Ellen E. Schultz, *Pay of Top Earners Erodes Social Security*, WALL ST. J., July 21, 2009, at C4. See also Cari Tuna, *Plush Perks Keep Flowing Despite Outcry*, WALL ST. J., April 3, 2009, at B1; Jonathan D. Glater, *Stock Options Are Adjusted After Many Share Prices Fall*, N.Y. TIMES, March 27, 2009, at B1; Shelly Banjo, *Corporate News: Stock Options Are Ailing, but Aren't Dead*, WALL ST. J., March 18, 2009, at B2. One type of pay practice caused considerable angst among the public – the payment of taxes for executives on certain perks. This practice, the so-called tax gross-up, has been under considerable pressure of late. See Cari Tuna, *Firms End Key Benefit for Executives*, WALL ST. J., April 21, 2009, at B1.

has boiled over an already simmering public, generating a level of public anger that is more focused and intense than anything that has preceded it – at least in this author’s lifetime.<sup>5</sup> One scholar presciently stated, “[c]hanging the business and financial culture by moving it away from the self-interest ideology will take time, and it may take a financial catastrophe to upset the status quo and lead people to question the dominant perspective.”<sup>6</sup> The financial catastrophe arrived, and the extent of its damage has led to unprecedented federal intervention in the financial system and other areas of the economy.<sup>7</sup> Much of the blame for our current economic situation has been placed squarely on compensation practices that critics assert encouraged inordinate risk-taking, were too focused on short-term results, and resulted in private gain but socialized losses.<sup>8</sup>

In response, the federal government has, both legislatively and administratively, interjected itself in the compensation arena to an extent that would have been inconceivable a few years ago.<sup>9</sup> Moreover, such federal intervention and the massive losses suffered by investors have emboldened shareholders to take a more proactive role in the executive-compensation process.<sup>10</sup> Boards of directors, in turn, have begun to take a more adversarial approach with executives in crafting compensation

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5. Compensation practices are by no means the sole factor upon which blame is laid for the current economic situation. See, e.g., *When a Flow Become A Flood*, ECONOMIST, Jan. 24, 2009, at 74-76 (discussing the United States’ meager savings rate and large trade imbalance); *Greed - and Fear*, ECONOMIST, Jan. 24, 2009, at 3 (positing that the failure of mathematical models to adequately assess risk and regulatory failures were also contributing causes). The opinion that compensation practices contributed to economic crisis is by no means universally held. See Floyd Norris, *It May Be Outrageous, but Wall Street Pay Didn’t Cause This Crisis*, N.Y. TIMES, July 31, 2009, at B1 (referring to an academic study that concludes that bank C.E.O. incentives were not to blame for credit crisis or poor bank performance).

6. James Fanto, *A Social Defense of Sarbanes-Oxley*, 52 N.Y.L. SCH. L. REV. 517, 525 (2007).

7. A recent Wall Street Journal/NBC News poll found that 69 percent of respondents were either greatly concerned or quite a bit concerned about the federal government’s role in the economy. See Laura Meckler, *Public Wary of Deficit, Economic Intervention*, WALL ST. J., June 18, 2009, at A1. Widespread federal government intrusion in the economy would be expected to displease advocates for the self-correcting properties of free markets, but it has also provided fodder for an apparently growing devolutionist movement. See Paul Starobin, *Divided We Stand*, WALL ST. J., June 13, 2009, at W1 (reporting on growing secessionist sentiments in Texas, Alaska, and Vermont).

8. See Gretchen Morgenson, *Gimme Back Your Paycheck*, N.Y. TIMES, Feb. 22, 2009, at BU1.

9. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

10. See Morgenson, *supra* note 8.

arrangements.<sup>11</sup> As a result, a portion of executive compensation increasingly has become subject to clawback provisions. Such provisions entitle the employer to recoup compensation paid or discharge the obligation to pay compensation in the event that, with the benefit of hindsight, such compensation was not earned.<sup>12</sup> Clawback provisions are not new. Certain officers of publicly traded companies have been subject to such provisions since 2002.<sup>13</sup> Contractual clawbacks have been used in limited settings for some time, and long-standing common law remedies have been available to employers under appropriate circumstances.<sup>14</sup> Federal legislation enacted in 2008 and 2009 has broadened the scope of such provisions.<sup>15</sup> Moreover, corporations have begun to incorporate such provisions in their executive compensation schemes with greater frequency.<sup>16</sup>

The repayment or forfeiture of compensation raises a myriad of tax issues for the affected executives. The federal income tax system operates on the basis of an annual accounting period.<sup>17</sup> The fact that compensation is taxed in one period and repaid or forfeited in a subsequent period will not, almost assuredly, result in tax neutrality. In addition to time value of money issues, the tax benefits attributable to the repayment or forfeiture of compensation will depend on various factors that may, or may not, place the executive in a position closely approximating the tax posture that such an executive would have found herself in had the compensation not been subject to tax in the first place.

11. See, e.g., Aaron Lucchetti, *Goldman's Blankfein Calls For Pay Change*, WALL ST. J., April 8, 2009, at C3; Kathryn Jones, *Who Moved My Bonus?*, N.Y. TIMES, April 5, 2009, at BU1; Phred Dvorak & Joann S. Lublin, *Firms Rethink Compensation Plans*, WALL ST. J., Jan. 20, 2009, at B1.

12. Compensation based on the attainment of certain metrics, such as earnings, earnings per share, revenue, and the like may ultimately have not been earned if such metrics are required to be restated. This is a common trigger in clawback provisions. See *infra* notes 35, 48, 58-60 and accompanying text. See also Louise Story, *Wall St. Profits Were a Mirage, but Huge Bonuses Were Real*, N.Y. TIMES, Dec. 18, 2008, at A1. United States accounting standards are, in many areas, subject to the exercise of judgment. In other respects, such standards are very "rules based" and, as such, may be manipulated in ways not contemplated by the drafters of such standards. See generally Franklin A. Gevurtz, *Corporate Governance and the Sarbanes-Oxley Act: Earnings Management and the Business Judgment Rule: An Essay on Corporate Scandals*, 30 WM. MITCHELL L. REV. 1261 (2004); Matthew A. Melone, *United States Accounting Standards – Rules or Principles? The Devil is Not in the Details*, 58 U. MIAMI L. REV., 1161 (2004).

13. See *infra* note 35 and accompanying text.

14. See *infra* notes 48-59 and accompanying text.

15. See, e.g., Emergency Economic Stabilization Act of 2008 (Bailout Bill), Pub. L. No. 110-343, 122 Stat. 3765 (2008); The American Recovery and Reinvestment Act, Pub. L. No. 111-5, 123 Stat. 115 (2009).

16. See *supra* note 11.

17. 26 U.S.C.A. § 441(b) (West 2009).

The tax consequences will depend on several factors, including the nature of the compensation subject to clawback, the circumstances surrounding the clawback, and the executives' unique tax position.<sup>18</sup>

Part I of this article discusses and analyzes clawbacks in general, including clawbacks that are part of common-law remedial schemes, federally legislated clawbacks, and those triggered by contractual clawback provisions. Part II of this article analyzes the tax consequences to the executives that result from the repayment or forfeiture of compensation. This part provides an analysis of the annual accounting concept and the claim-of-right doctrine which will generally result in the payment and return of compensation to be accounted for in separate tax years and, concomitantly, will generally result in incongruent tax consequences. The exceptions to the annual accounting concept are discussed with particular emphasis on Section 1341, an ameliorative provision. The tax consequences arising from the clawback of compensation are heavily dependent upon the tax treatment of the compensation that is clawed back. Accordingly, a detailed discussion of the tax treatment of cash and equity-based incentive compensation schemes is provided. In many cases, the tax treatment of clawbacks is relatively straightforward – albeit somewhat punitive. However, in certain instances, the tax consequences to executives subject to clawback provisions are uncertain.

## II. COMPENSATION CLAWBACKS

### *A. In general*

Compensation clawbacks can be, and have been, supported by long-standing state law legal and equitable principles.<sup>19</sup> Active participation by executives in the material misstatement of financial or other information presented to the board of directors or shareholders constitutes a breach of the duties of candor, good faith, and loyalty and

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18. See *infra* Part II.

19. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 304(a), 15 U.S.C. § 7243 (2006) (requiring the CEO and CFO of a materially noncompliant issuer to disgorge profits and refund to the company any bonuses earned within the last twelve months); David Blumenthal, *Source of Funds and Risk Management for International Energy Projects*, 16 BERKELEY J. INT'L L. 267, 293 (1998) (discussing clawback provisions as a way for commercial lenders to mitigate risk); George P. Roach, *A Default Rule of Omnipotence: Implied Jurisdiction and Exaggerated Remedies in Equity for Federal Agencies*, 12 FORDHAM J. CORP. & FIN. L. 1 (2007) (discussing restitution, disgorgement of profits, and clawback provisions).

would provide ample support for a cause of action for damages or, alternatively, restitution.<sup>20</sup>

An agent's breach of fiduciary duty is a basis on which the agent may be required to forfeit commissions or other compensation paid or payable to the agent during the period of the agent's disloyalty. The availability of forfeiture is not limited to its use as a defense to an agent's claim for compensation.<sup>21</sup>

Moreover, the equitable remedy of restitution may be sought regardless of whether the executive in question deliberately participated in the conduct that resulted in the material misstatement. In a relatively recent—and prominent—case, the Delaware Chancery Court, in a derivative action, granted the plaintiffs' motion for summary judgment that the former chief executive officer of HealthSouth Corp., Richard Scrushy, was unjustly enriched by the repayment of a loan with stock whose value was inflated by accounting irregularities that subsequently were disclosed to the public.<sup>22</sup> The plaintiffs made no claim of

20. *See id.* In cases where the executive had no direct hand in perpetrating the misstatement, but was duped by subordinates, it is likely that, absent gross negligence, the executive will be protected from breach-of-duty claims by the business judgment rule. *See* A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992). *But see* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (arguing that the business judgment rule should not protect non-director officers). Professor Lyman's distinction between officers and directors in the application of the business judgment rule has prompted some criticism. *See generally* Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005). The business judgment rule provides legal cover for actions undertaken in good faith and made with all due care and recognizes that directors, not shareholders, manage the corporation. A party challenging the board's decision must overcome a presumption that "the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action was in the best interest of the company." *Orman v. Cullmann*, 794 A.2d 5, 19-20 (Del. Ch. 2002) (quoting *Arenson v. Lewis*, 473 A.2d 805, 812 (Del. Ch. 1984)). The term "restitution" is often used interchangeably with the term "disgorgement." The former term is a remedy intended to make the injured party whole while the latter focuses on the wrongdoer and seeks to divest the recipient of the receipt of unjust benefits. *See* REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, 19 (Securities and Exchange Commission 2003), available at <http://www.sec.gov/news/studies/SOA308creport.pdf>.

*See also* Andrew Kull, *Rescission and Restitution*, 61 BUS. LAW. 569, 574-79 (2006) (discussing efforts by the American Law Institute to clarify the standard for restitution).

21. RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. d(2). For an excellent analysis of equitable remedies in this context, see Manning Gilbert Warren III, *Equitable Clawback: An Essay on Restoration of Executive Compensation* (May 19, 2009), available at <http://ssrn.com/abstract=1407129>.

22. *In re HealthSouth Corp.*, 845 A.2d 1096 (Del. Ch. 2003). A similar result would be supported by a claim of innocent misrepresentation or mutual mistake of fact. *Id.* at 1106-07. In the case of mutual mistake of fact, the risk of loss will be allocated to the party in the better position to prevent or recognize the mistake. Usually, as between a chief executive or chief financial officer and the company, the former should be in a better position to prevent or be cognizant of the mistake.

wrongdoing by the executive nor, in the opinion of the court, was such a claim necessary. “[W]hether or not Scrusby breached a cognizable duty . . . he was undoubtedly unjustly enriched . . . .”<sup>23</sup> The Alabama Supreme Court applied similar reasoning in requiring that Scrusby forfeit bonuses he received from HealthSouth.<sup>24</sup> Contractual provisions that limit or preclude restitution may present obstacles to recovery, but such obstacles may be overcome if the contract, including its provisions limiting or barring restitution, is tainted by fraud or if some other contract law defense is available, including violations of public policy.<sup>25</sup>

Corporations, however, are often reluctant to seek common-law remedies against executives and shareholders and are often stymied in their attempts to bring derivative actions or other private causes of action.<sup>26</sup> Moreover, settlement of claims that are brought generally

*See, e.g.,* Roberts v. Century Contractors, Inc., 592 S.E.2d 215 (N.C. Ct. App. 2004). Such claims would not be supportable if the misstatement occurred after the contract was formed, however. Scrusby, acquitted of criminal charges in 2005, was recently ordered to pay \$ 2.88 billion in a civil action. *See* Valerie Bauerlein & Mike Esterl, *Judge Orders Scrusby to Pay \$2.88 Billion in Civil Suit*, WALL ST. J., June 19, 2009, at B1.

23. *Id.* at 1106.

24. Scrusby v. Tucker, 955 So. 2d 988, 1012 (Ala. 2006). Miller v. U.S. Foodservice, Inc., 361 F.Supp. 2d 470, 484-85 (D. Md. 2005), in dicta, would limit restitution to cases involving the breach of a contractual duty).

25. *See* Wal-Mart Stores, Inc. v. Coughlin, 255 S.W.3d 424 (Ark. 2007)(voiding a retirement agreement and release of claims due to fraudulent misrepresentations). *See also* Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability, 42 WAKE FOREST L. REV. 627, 646-47 (2007). In extreme cases, such as AIG, some commentators believe that bonuses could be recouped on unconscionability grounds or by asserting that such compensation payments amounted to fraudulent conveyances. *See, e.g.,* Lawrence A. Cunningham, *A.I.G.’s Bonus Blackmail*, N.Y. TIMES, March 18, 2009, at A27. New York State Attorney General Andrew Cuomo used this rationale to compel AIG to recover bonuses and other compensation paid to certain executives. *See* David S. Hilzenrath, *AIG Limits Pay of Its Top Executives*, WASH. POST, Nov. 26, 2008, at D01. Some members of Congress attempted another approach—punitive taxation of erstwhile improper bonuses. *See* H.R. 1586, § 1(a), 111th Cong., 1st Sess., March 23, 2009 (imposing a tax of 90 percent on disqualified bonus payments); Jonathan Weisman et al., *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J., March 18, 2009, at A1.

26. A decision not to seek repayment of compensation is subject to the cover provided by the business judgment rule. Although the business judgment rule is inapplicable to self-interested decisions, the Delaware courts have extended the doctrine’s protection to executive compensation related matters in cases where the board of directors is comprised of a majority of independent directors. *See, e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 365 (Del. 1994). Business judgment protection has been codified with respect to stock option plans. “In the absence of actual fraud . . . the judgment of the directors as to consideration for the issuance of . . . options and the sufficiency thereof shall be conclusive.” DEL. CODE ANN. tit.8, § 157 (1991). Moreover, extraordinarily generous compensation packages containing terms that are extremely favorable to executives are not subject to a “fairness” standard but instead are challengeable only if such packages amount to waste of corporate resources. An act by directors that constitutes a waste of corporate assets is void. Eric L. Johnson, Note, *Waste Not, Want Not: An Analysis of Stock Option*



result in the enterprise, or its insurance carrier, funding the settlement—what one commentator has referred to as the “double victimization” of the shareholders.<sup>27</sup> Public outrage directed at the compensation practices of Wall Street, perceived to be one of the root causes of the current economic dislocations, has put pressure on boards of directors to put in place mechanisms that force the disgorgement or forfeiture of compensation that, based on some standard of fairness, ought not be retained or paid.<sup>28</sup> Legislative developments in the aftermath of the Enron and WorldCom scandals required clawbacks in limited circumstances.<sup>29</sup> More recently, as part of the federal bailout of financial institutions, a new set of mandated clawbacks have been legislated.<sup>30</sup>

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*Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 154 (2000). The classical waste standard found waste to have occurred if “no person of ordinary, sound business judgment would deem the consideration the corporation received worth what the corporation . . . paid.” *Id.* at 155 (quoting *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)). See also *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997). The failure of shareholders to recoup the severance payments paid by Walt Disney Co. to Michael Ovitz and the failure of Fannie Mae to seek recoupment of incentive compensation from ex-CEO Franklin Raines after a multi-billion earnings restatement evidences the difficulty facing shareholders of a corporation reluctant to pursue executives on its own. See Steven H. Kropp, *Corporate Governance, Executive Compensation, Corporate Performance, and Worker Rights in Bankruptcy: Some Lessons From Game Theory*, 57 DEPAUL L. REV. 1, 32-35 (2007) (discussing the Michael Ovitz case); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 IOWA J. CORP. L. 807, 810-11 (2005). Shareholder challenges to executive compensation would come in the form of derivative litigation. See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 779 (2002). As such, the shareholders must first, with one exception, make a demand on the board to investigate the claim and consider whether further action is appropriate. *Id.* at 870. In almost all cases, the board, perhaps through a special litigation committee, will seek to have the action terminated. See Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 576-77 (2001). The exception to the demand requirement requires that shareholders establish that making such demand is futile by offering particularized facts that create reasonable doubt that the directors are independent and that the board is otherwise not protected by the business judgment rule—a difficult proposition. See Bebchuk et al., *supra*, at 780-81. Shareholder action is further inhibited by the recent developments that have tended to create obstacles to private causes of action. See generally Faith Stevelman, *Corporate Governance Five Years After Sarbanes-Oxley: Is There Real Change?*, 52 N.Y.L. SCH. L. REV. 475, 495-96 (2007) (describing legislation and court decisions that have had a detrimental impact on private securities law litigation).

27. Langevoort, *supra* note 25, at 632.

28. See *supra* notes 4-11 and accompanying text.

29. See *supra* note 9.

30. 12 U.S.C.A. § 5221 (West 2009).

## B. Federal Legislation

### 1. Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002<sup>31</sup> was enacted in the aftermath of the brazen frauds at Enron and WorldCom. Arguably, the most far-reaching effects of this legislation have been felt by the accounting profession.<sup>32</sup> However, the Sarbanes-Oxley Act did address certain perceived abuses in the executive suite. Included among its provisions are the imposition of trading bans during pension blackout periods, a requirement of timelier reporting of insider transactions, certification requirements for financial statements, and the grant of authority to the Securities and Exchange Commission to seek a court order to temporarily freeze extraordinary payments to directors, executives, employees, and certain other persons.<sup>33</sup>

Section 304 of the Sarbanes-Oxley Act provides for the clawback of compensation.<sup>34</sup> This provision, however, applies in limited circumstances. Section 304 is applicable only to chief executive and chief financial officers of publicly traded entities, and only if the company is required to restate its financial results as a result of material noncompliance with any financial reporting requirement under the federal securities laws.<sup>35</sup> Moreover, the material misstatement must have occurred as a result of misconduct—a term left undefined by the

31. Pub. L. No. 107-204, 15 U.S.C. § 7201 et. seq. (2006).

32. Sarbanes-Oxley Act of 2002, §§ 101-206, 116 Stat. 746-74 (2002). The legislation, *inter alia*, created the Public Accounting Oversight Board with significant regulatory powers over firms conducting audits of publicly traded corporations, prohibited independent accounting firms from auditing public companies if certain officers of the company were employed by the audit firm within the one year period preceding the audit, and instituted mandatory audit partner rotation. *See id.*

33. *See, e.g.,* S.E.C. v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1044-45 (9th Cir. 2005)(en banc)(broadly defining the term “extraordinary payment”). Pension blackout periods are periods in which participants in qualified plans are prohibited from trading employer securities. This provision was enacted as a result of the losses suffered by Enron employees by their inability to sell their Enron stock during the rapid decline in the value of such stock once Enron’s accounting came under public scrutiny. *See* Sarbanes-Oxley Act of 2002, §§ 302, 306, 401-403, 1103, 116 Stat. 777, 779-84, 785-89, 807 (2002).

34. Sarbanes-Oxley Act of 2002 at § 304.

35. Sarbanes-Oxley Act of 2002, §§ 304(a), 116 Stat. 778 (2002) (codified at 15 U.S.C. § 7243 (2006)). A recent federal district court decision interpreted the statute to require an actual restatement of earnings to be filed with the Securities and Exchange Commission in order to trigger the clawback obligation. A mere discovery of accounting discrepancies will not suffice. *S.E.C. v. Shanahan*, 624 F.Supp. 2d 1072, 1077-78 (E.D. Mo. Dec. 12, 2008).

statute.<sup>36</sup> In the event that Section 304 applies, its reach is, in part, both narrow and broad. It is narrow in the sense that the clawback is limited to compensation received in the twelve-month period following the first public issuance or filing with the Securities and Exchange Commission of the financial document that was ultimately restated.<sup>37</sup> However, during this relatively narrow window, the reach of the clawback is fairly broad, encompassing any bonus, incentive-based or equity-based compensation, and any profits received from the sale of employer securities during the applicable period.<sup>38</sup>

The statutory language requires that all such compensation be returned, regardless of whether a portion of such compensation would have been payable notwithstanding the restatement.<sup>39</sup> The courts have held that there is no implied private right of action under section 304,

36. Sarbanes-Oxley Act of 2002, §§ 304(a), 116 Stat. 778 (2002) (codified at 15 U.S.C. § 7243 (2006)). The statutory language also fails to make clear whether this provision is triggered by the misconduct of any person or whether such misconduct must be perpetrated by the chief executive or chief financial officer. Until recently, most practitioners believed that the Securities and Exchange Commission would bring an action against an executive under § 304 only if such executive had a hand in the misconduct. However, the Securities and Exchange Commission has sought to impose § 304 against the former chief executive officer of CSK Auto Corp. due to the misconduct of several subordinate executives. *See* Complaint for Violations of Section 304 of the Sarbanes-Oxley Act of 2002, S.E.C. v. Jenkins, No. 2:09-cv- 01510-JWS (D. Az. July 22, 2009).

37. Sarbanes-Oxley Act of 2002, §§ 304(a)(1)-(2), 116 Stat. 778 (2002). Rep. Barney Frank of Massachusetts introduced legislation that would have expanded the coverage of § 304 to include the disgorgement of profits generated from the exercise of stock options by the five most highly compensated officers and directors if the price of the stock underlying the options declined by a material amount at the end of a twelve-month period following the exercise of options by any such officers or directors. *See* Executive Stock Option Profit Recapture Act, H.R. 4208, 108th Cong., 2d Sess., April 22, 2004.

38. Sarbanes-Oxley Act of 2002, §§ 304(a)(1)-(2), 116 Stat. 778 (2002). Note, however, that post-retirement payments are not included in the classes of income subject to clawback, regardless of whether those payments have been inflated by phantom earnings. Post-retirement arrangements are an effective method of camouflaging compensation. *See* Bebchuk & Fried, *supra* note 26, at 815. The Securities and Exchange Commission has recently approved a request by the Chicago Board Options Exchange to modify its margin requirement to facilitate the writing of covered calls on employee stock options. *See* Exchange Act Release No. 34-61026 (June 17, 2009), *available at* <http://www.sec.gov/rules/sro/cboe/2009/34-61026.pdf>. Under the new rule, vested stock options could be used as collateral for covered calls written on the stock underlying the options. Prior to this change, holders of stock options had to post cash collateral in order to write call options, a requirement that often made such a strategy prohibitively expensive. Consequently, it is likely that such strategies will become more prevalent. The language of § 304 does not appear to capture the income from writing such call options. Covered call writing is a common technique to “juice” returns from stock holdings. An aggressive interpretation of § 304 could include the income from such activities if the underlying stock has been sold. *Id.*

39. The Securities and Exchange Commission has the authority to exempt persons from the application of this provision. Sarbanes-Oxley Act of 2002, §§ 304(b), 116 Stat. 778 (2002).

and its impact to date has been relatively modest.<sup>40</sup> However, its enactment did bring public awareness to the lack of willingness on the part of corporate boards to insist on disgorgement of bonuses and other incentive compensation that, in hindsight, had not been earned.<sup>41</sup> The Sarbanes-Oxley Act can be viewed “as an expression of social outrage at misconduct by some members of the elite . . . .”<sup>42</sup> Unfortunately, it took almost a decade and an economic catastrophe for clawbacks to figure prominently in executive-compensation schemes.

## 2. Financial Bailout Legislation

The Emergency Economic Stabilization Act of 2008<sup>43</sup> contained restrictions on executive compensation applicable to financial institutions that sell troubled assets to the U.S. Department of the Treasury (Treasury), pursuant to its provisions.<sup>44</sup> In the event that the Treasury purchases troubled assets directly from a financial institution and receives a meaningful equity or debt position in the financial institution the legislation prohibits both compensation arrangements with senior executive officers that include incentives to take unnecessary and excessive risks and golden parachute payments.<sup>45</sup> A senior executive

40. See, e.g., *Kogan v. Robinson*, 432 F.Supp. 2d 1075 (S.D. Calif. 2006); *In re Bisys Group, Inc. Derivative Action*, 396 F.Supp. 2d 463, 464 (S.D. N.Y. 2005); *Neer v. Pelino*, 389 F.Supp. 2d 648, 657 (E.D. Pa. 2005). The board’s response to the massive restatement of earnings at Fannie Mae is instructive in this respect. See *Bebchuk & Fried, supra* note 26. See also Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 13 (2008). The Securities and Exchange Commission used its authority under § 304 to reach a settlement with William McGuire in 2007 that required McGuire, the former CEO of UnitedHealth Group, Inc. to return approximately \$448 million of compensation to his former employer. See *Securities and Exchange Commission v. William W. McGuire, M.D.*, Litigation Release No. 20387 (Dec. 6, 2007).

41. *Supra* note 8.

42. *Fanto, supra* note 6, at 521.

43. Pub. L. No. 110-343, 122 Stat. 3765 (2008). This legislation authorizes the Secretary of the Treasury to establish the Troubled Asset Relief Program (TARP) to “purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary . . . .” Emergency Economic Stabilization Act of 2008, § 101, 122 Stat. 3767 (2008). The sale of troubled assets to the federal government by financial institutions may take place directly—the capital purchase program—or by auction. Participants in the direct purchase program are subject to much more stringent compensation limitations than those participating through auction. In addition, the Treasury has instituted other programs such as the Term Asset-Backed Securities Loan Facility and programs tailored to specific institutions. See *infra* note 45 and accompanying text.

44. *Id.* at § 111.

45. Emergency Economic Stabilization Act of 2008, § 111(b)(1)-(2), 122 Stat. 3765, 3776-77 (2008). If the Treasury purchases troubled assets through auction and such purchases exceed \$300,000,000, the legislation prohibits golden parachute arrangements with senior executive

officer is defined as one of the top five highly paid officers, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and non-public company counterparts.<sup>46</sup> The legislation also amended I.R.C. section 162(m) to limit the tax deduction for compensation to covered executives to \$500,000.<sup>47</sup> In addition, this legislation requires that compensation arrangements for senior executive officers provide for the recovery of any bonuses or incentive compensation paid that were based on earnings, gains, or other criteria that are later proven to be materially inaccurate.<sup>48</sup> Unlike Section 304 of the Sarbanes-Oxley Act of 2002, this clawback requirement is intended to be enforced by the affected companies, does not require that the

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officers that apply in the event of such officer's involuntary termination, or in connection with the financial institution's bankruptcy filing, insolvency, or receivership. Emergency Economic Stabilization Act of 2008, § 111(c) 122 Stat. 3777 (2008). Golden-parachute payments are defined, for this purpose, as compensatory payments whose present value exceeds three times the executive's base amount. The base amount is defined by reference to I.R.C. § 280G(b)(3) and the regulations thereunder. See U.S. Dep't. of the Treas. Notice 2008-TAAP (Oct. 14, 2008), available at <http://www.financialstability.gov/docs/Exec%20Comp%20TAAP%20Notice.pdf>. Moreover, the financial institution may not deduct executive compensation in excess of \$500,000 for each executive nor may any golden parachute payment be deducted. In addition, a 20 percent excise tax is imposed on executives receiving golden-parachute payments. See Emergency Economic Stabilization Act of 2008, § 302, 122 Stat. 3803-06 (codified at 26 U.S.C. § 162(m)(5) and 26 U.S.C. 280G(e)); I.R.S. Notice 2008-94, 2008-44 I.R.B. 1070 (Nov. 11, 2008). The Treasury announced plans to develop a more stringent set of restrictions for systematically significant failing institutions. See U.S. Dep't. of the Treas. Notice 2008-PSSFI (Oct. 14, 2008), available at <http://www.treas.gov/press/releases/reports/exec%20comp%20pssfi%20notice%20revised.pdf>. Moreover, the Treasury announced new rules for financial institutions that receive exceptional assistance. These rules apply to financial institutions that need more assistance than that available under the terms of the standard programs. Included among such institutions are Citigroup, Bank of America, and AIG. See Press Release, U.S. Dep't. of the Treas., Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at <http://www.treas.gov/press/releases/tg15.htm>. The government has taken an aggressive stance with such entities. See Michael R. Crittenden & John D. Knoll, *Treasury Toughens Its TARP Contracts*, WALL ST. J., Jan. 28, 2009, at C3. Moreover, President Obama has appointed Kenneth R. Feinberg as special master for compensation. In that role, Feinberg will oversee compensation related matters for the firms that have received exceptional assistance from the federal government. See Louise Story & Stephen Labaton, *Overseer of Big Pay is Seasoned Arbitrator*, N.Y. TIMES, June 11, 2009, at B1. Note that the tax-deduction limitations imposed by the act do not contain an exception for performance-based compensation and apply to non-public recipients of assistance. See *supra* note 2 for a discussion of the general limitation on the deductibility of executive compensation.

46. Emergency Economic Stabilization Act of 2008, § 111(b)(3), 122 Stat. 3765, 3777 (2008).

47. Emergency Economic Stabilization Act of 2008, § 302(a), 122 Stat. 3765 (2008). See *supra* note 2 for a discussion of the general limitation on tax deductions for executive compensation. The Treasury also issued an interim final rule that requires financial institutions to agree, as a condition of participation in the capital purchase program, that tax deductions will be limited to \$500,000 for compensation paid to a senior executive officer. See Tarp Capital Purchase Program, 73 Fed. Reg. 62,205 (Oct. 20, 2008) (codified at 31 C.F.R. § 30).

48. Emergency Economic Stabilization Act of 2008, § 111(b)(2)(B), 122 Stat. 3765 (2008).

restatement be due to misconduct, applies to non-public institutions, and is applicable to restatements of any performance metrics.<sup>49</sup> In contrast to Section 304 of the Sarbanes-Oxley Act of 2002, the legislation does not require the clawback of gains realized from the sale of securities.<sup>50</sup> These provisions are to remain in effect for as long as the Treasury holds a meaningful equity or debt position in the company.<sup>51</sup>

The American Recovery and Reinvestment Act of 2009<sup>52</sup> amended the executive-compensation provisions of the Emergency Economic Stabilization Act of 2008. The Act subjects any entity that has, or will, receive financial assistance under the Troubled Asset Relief Program (TARP) to compensation standards.<sup>53</sup> Such standards are to remain in

49. See generally The Emergency Economic Stabilization Act of 2008.

50. See *infra* note 51 and accompanying text.

51. Emergency Economic Stabilization Act of 2008, § 111(b)(1), 122 Stat. 3765, 3777 (2008). Section 111(b)(1) requires that “financial institutions meet appropriate standards of executive compensation . . . .” This language appears to require that the financial institution itself institute the clawback provisions and, therefore, such clawbacks should be enforceable by the institutions themselves. *Id.*

52. Pub. L. No. 111-5, 123 Stat. 115 (2009).

53. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 516, 517 (2009). The Act also requires recipients of TARP assistance to form board compensation committees comprised entirely of independent directors. Moreover, shareholders of assistance recipients are entitled to a non-binding vote on executive compensation. *Id.* at 519-20 (2009). The Securities and Exchange Commission has recently proposed a new Rule 14a-20 that would implement the statutory mandate. Under the proposed rule, publicly held TARP recipients would be required to provide separate shareholder votes in proxies solicited for an annual meeting of security holders, or special meeting in lieu of an annual meeting. See Exchange Act Release No. 34-60218 (July 1, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60218.pdf>. This “say on pay” requirement has been a corporate governance issue for quite some time. It is not clear how shareholders will respond but there are indications that they may be ready for some muscle flexing. See Phred Dvorak, *Investors Diverge as Votes on Pay Near*, WALL ST. J., April 14, 2009, at B3; Craig Karmin, *Shareholders Renew Push to Regulate Executive Pay*, WALL ST. J., Feb. 13, 2009, at C1. The Securities and Exchange Commission has not provided shareholders of non-TARP recipients with a “say on pay,” although some prominent companies, such as Verizon Communications and Motorola, have provided shareholders with a nonbinding vote on executive compensation. See Joann S. Lublin, *A Quiet Response to ‘Say on Pay’ Measures – So Far This Season, Shareholders are Supporting Compensation Packages, Most Board Nominees*, WALL ST. J., May 18, 2009, at B6. During the current proxy season, as of August 15, 2009, 68 shareholder proposals for an advisory vote on executive compensation have been submitted and have garnered 45.8 percent of the votes cast. See 2009 PROXY SEASON SCORECARD (RiskMetrics Group 2009), available at [http://www.riskmetrics.com/knowledge/proxy\\_season\\_scorecard\\_2009](http://www.riskmetrics.com/knowledge/proxy_season_scorecard_2009). The House of Representatives has passed a bill that would require publicly traded entities to provide shareholders with a nonbinding vote on executive compensation and golden parachute arrangements. See Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. § 2 (2009). Shareholders of British firms do have the ability to cast advisory votes on compensation matters and have increasingly dissented on management proposals—including a remarkable 59 percent vote against the compensation plans of Royal Dutch Shell Group. See Muck, Brass and Spleen, *ECONOMIST*, May 21, 2009, at 70; Guy Chazan & Joann S. Lublin, *Shell Investors Revolt*

effect for so long as any obligation under the TARP program remains outstanding.<sup>54</sup> The compensation standards under the act retain the prohibition on incentives that lead to unnecessary and excessive risk, impose the previously discussed tax deduction limitations more broadly, further restrict golden parachute payments, and expand the clawback provisions to include retention bonuses.<sup>55</sup> Moreover, the number of employees whose compensation is subject to clawback is expanded to include, in addition to senior executive officers, the next twenty most highly compensated employees.<sup>56</sup> The legislation also prohibits the payment or accrual of any bonus, retention award, or incentive compensation during the period that an obligation under the TARP program remains outstanding.<sup>57</sup> An exception is made for the payment of restricted stock provided, however, that such stock does not fully vest during the period in which any obligation under the TARP program remains outstanding and that the value of such stock does not exceed one-third of the recipient's total compensation.<sup>58</sup> The prohibition on the payment of incentive compensation would seem to limit the applicability of clawback provisions applicable to such payments. However, the class

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*Over Executive Pay Plan*, WALL ST. J., May 20, 2009, at B1. The Obama administration has recently sought legislation that would grant shareholders a say on executive-compensation arrangements. See Stephen Labaton, *Treasury to Set Executives' Pay at 7 Ailing Firms*, N.Y. TIMES, June 11, 2009, at A1. The Obama administration has also proposed rules that would strengthen the independence of board-compensation committees and regulate the practices of compensation consultants. See *Principles, Not Pitchforks*, ECONOMIST, June 11, 2009, at 68.

54. The standards are not applicable if the Federal Government holds only warrants to purchase common stock of the TARP recipient. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 517 (2009). The Auto Industry Financing and Restructuring Act would have imposed similar restrictions on the compensation of executives of automobile manufacturers. See H.R. 7321, § 12(b) 110th Cong., 2d Sess., Dec. 10, 2008.

55. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 517 (2009). See also *supra* notes 43-51 and accompanying text. The number of employees restricted from receiving golden-parachute payments is expanded to include, in addition to senior executive officers, the next five most highly compensated employees. Moreover, the definition of golden-parachute payments is modified to include any payments for departure from a company for any reason, except for payments for services rendered or benefits accrued. *Id.*

56. American Recovery and Reinvestment Act of 2009, § 7001, 123 Stat. 517 (2009).

57. *Id.* This prohibition does not apply to any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009. American Recovery and Reinvestment Act of 2009, § 7001, 123 Stat. 518 (2009). However, the Treasury may review pre-enactment compensation of senior executive officers and the next twenty most highly compensated employees of TARP recipients and require, if such compensation is deemed inconsistent with the purposes of the Act or the TARP, such employees to reimburse the federal government with respect to such compensation. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 520 (2009).

58. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 518 (2009).

of executives to whom the clawback provisions apply may be broader than the class of executives to whom the payment prohibition applies.<sup>59</sup>

### C. Contractual Clawback Provisions

Whether, as a policy matter, legislated or administratively mandated curbs on executive compensation are effective is beyond the scope of this work.<sup>60</sup> Public opprobrium directed at Wall Street and the banking industry does create the risk that political considerations will lead to overly restrictive compensation practices that stifle prudent risk-taking activities. On the other hand, the fact that clawback provisions had to be legislated speaks volumes about the failure of boards to adequately police executive compensation arrangements. It should come as no surprise that the government filled the vacuum left by private industry. What is certain is that the federal government's efforts have created a great deal of uncertainty with respect to executive compensation practices and have led, and will continue to lead, to attempts to avoid government imposed restrictions.<sup>61</sup> The economic

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59. The provisions limiting such payments and the exception thereto apply to a number of employees of the TARP recipient that depends on the amount of financial assistance received. For assistance less than \$25,000,000 these provisions apply to the most highly compensated employee. For assistance between \$25 million and \$249,999,999 these provisions apply to the five most highly compensated employees. *Id.* at § 111(b)(3)(C)(ii)(II). For assistance between \$250 million and \$499,999,999 these provisions apply to the senior executive officers and the 10 most highly compensated employees. *Id.* at § 111(b)(3)(C)(ii)(III). For assistance of \$500 million or more these provisions apply to the senior executive officers and twenty most highly compensated employees. *Id.* at § 111(b)(3)(C)(ii)(IV).

60. The statutory curbs have been criticized on several grounds. The restrictions target incentive compensation which, according to critics, will lead to a greater reliance on base salaries not tied to performance. *See* Eric Dash, *Citigroup Has a Plan to Fatten Salaries*, N.Y. TIMES, June 24, 2009, at B1. According to such critics, the problem was not incentive compensation per se but the incentive structures in place. Other criticisms include assertions that such restrictions will lead to a flight of talent out of the financial sector, that the curbs are unconstitutional, and, at the other end of the spectrum, that they don't go far enough. *See, e.g.,* Susanne Craig & Joann S. Lublin, *Financials Post Sign of Times: CEO Wanted*, WALL ST. J., June 24, 2009, at C1; David Gillen, *The Brain Drain Defense*, N.Y. TIMES, Feb. 22, 2009, at WK1; Judith F. Samuleson & Lynn A. Stout, *Are Executives Paid Too Much?*, WALL ST. J., Feb. 26, 2009, at A13; Lucian Bebchuk, *Pay Caps Debate: They Don't Go Far Enough . . .*, WALL ST. J., Feb. 6, 2009, at A11; Andrew P. Napolitano, *. . . They Violate Good Sense and the Constitution*, WALL ST. J., Feb. 6, 2009, at A11. According to data released by New York Attorney General Andrew Cuomo, nine banks that received TARP funding paid approximately \$33 billion in bonuses in 2008. *See* Susanne Craig & Deborah Solomon, *Bank Bonus Tab: \$33 Billion*, WALL ST. J., July 31, 2009, at A1. Although overall compensation expenses at these institutions were less in 2008 than in 2007, as a percentage of revenues compensation expense actually increased in 2008 from the comparable figures in 2007. *Id.*

61. The statutory curbs on compensation are not a model of clarity and raise a number of implementation issues. For example, the pay curbs imposed on a defined number of highly



crisis, and the federal government's response to it, has, however, changed the nature of the debate with respect to executive compensation in the private sector. In industries far removed from Wall Street, boards are approaching executive compensation in a much more adversarial fashion and are instituting long needed reforms, including clawback provisions.<sup>62</sup>

Contractual clawback provisions are commonly used as part of non-compete and non-disclosure agreements.<sup>63</sup> For the most part, such provisions have withstood legal challenges.<sup>64</sup> More recently, however, such provisions have become a more prominent feature in executive compensation arrangements.<sup>65</sup> A recent survey by The Corporate

compensated employees, discussed at *supra* notes 55-59 and accompanying text, do not provide guidance as to when a company is to make the determination of which employees are covered by the curbs. Moreover, the incentive pay curbs virtually assure that employees that are covered in a given period will not be the most highly compensated in the subsequent period. It is not clear if the legislation had in mind a revolving door of persons covered. Moreover, the Treasury is given wide discretion in setting terms with firms that receive extraordinary assistance. Without some sort of standards private firms face a tremendous amount of uncertainty. The Obama administration has appointed a Special Master of Compensation to coordinate compensation related issues. See Deborah Solomon, *U.S. News: White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A4. Firms are also beginning to restructure compensation arrangement to provide greater emphasis on base salaries. In addition, the executive compensation curbs have been a contributing factor that have led many firms to seek to repay TARP funds as quickly as possible. See Aaron Lucchetti, *Morgan Stanley Boosts Salaries As Its Bonuses Are Limited*, WALL ST. J., May 23, 2009, at B1; Mark Maremont & Joann S. Lublin, *Loopholes Sap Potency of Pay Limits*, WALL ST. J., Feb. 6, 2009, at C1; Eric Dash, *10 Large Banks Allowed to Exit U.S. Aid Program*, N.Y. TIMES, June 10, 2009, at A1 (reporting that ten financial institutions have been allowed to repay \$68.3 billion, more than a quarter of the funds received by banks since October 2008).

62. It is ironic, given the general perception that professional athletes are coddled and excessively compensated, that one enterprise that has aggressively enforced clawback provisions is the National Football League. Professional football player contracts are unique in that, unlike the contracts of professional baseball, basketball, and hockey players, football player contracts are not guaranteed. See generally Robert Forbes, Note, *Call on the Field Reversed: How the NFL Players Association Won Big on Salary Forfeiture at the Bargaining Table*, 6 VA. SPORTS & ENT. L.J. 333, 336-37 (2007). As a result, players commonly negotiate signing bonuses that provide substantial up-front money to the players. *Id.* at 337. The collective bargaining agreement between the National Football League Players' Association and the team owners provides for a clawback of signing bonuses under numerous circumstances. *Id.* at 337-38.

63. Such provisions are subject to the challenges that are typically brought against non-compete agreements, such as unreasonable restraint of trade issues. With respect to the forfeiture of options or stock, these provisions are sometimes challenged on the grounds that such provisions represent an unreasonable restraint on alienation or that such provisions cannot co-exist with requests for injunctive relief. See generally Richard E. Wood, *Bad Boys (and Girls) Get Clawed Back*, 18 BENEFITS L. J. 84, 90-93 (2005).

64. *Id.*

65. Gretchen Morgenson, *Pay It Back If You Didn't Earn It*, N.Y. TIMES, June 8, 2008, at BU1 (reporting on a survey of 2,121 companies). Although 14 percent of the sample appears meager, it is a substantial improvement from the less than 8 percent result from a similar study

Library found that 14 percent of surveyed corporations instituted some form of contractual clawback feature in their executive compensation arrangements.<sup>66</sup> Approximately 44 percent of these provisions are triggered by fraud or some other form of misconduct while approximately 39 percent are crafted to recoup funds because of financial restatements.<sup>67</sup> The Securities and Exchange Commission's compensation disclosure rules require that corporations disclose their clawback policies in their proxy statements as part of the broader discussion of executive compensation policies.<sup>68</sup> Shareholders have become increasingly assertive in proposing that clawback policies be adopted or strengthened and the Securities and Exchange Commission has viewed corporate attempts to keep such proposals out of the proxy statements with skepticism.<sup>69</sup>

The implementation of contractual clawback provisions raises a host of managerial and legal issues. On the one hand, corporations should design these provisions to incorporate basic notions of fairness in the event that performance metrics have not been met and, moreover, to

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conducted in 2003. *See id.* (reporting that only fourteen companies had clawback provisions four years prior). The survey, Paul Hodgson, *2008 Proxy Season Foresights #11*, Analyst Alert (The Corporate Library, June 4, 2008), is available for purchase from The Corporate Library. Another study by Equilar, Inc. found that 42.1 percent of the Fortune 100 companies have instituted clawback policies by 2006. *See* CLAWBACKS OF EXECUTIVE COMPENSATIONS (Gibson, Dunn & Crutcher, LLP July 9, 2008), available at <http://www.gibsondunn.com/Publications/Pages/ClawbacksOfExecutiveCompensation.aspx>.

66. *Id.*

67. *Id.*

68. 17 C.F.R. § 229.402(b)(2)(viii) (2008).

69. In the period between January 2004 and June 2008, thirty-two shareholder proposals requesting the implementation of clawback provisions were submitted. CLAWBACKS OF EXECUTIVE COMPENSATIONS, *supra* note 65. The proposals garnered the most shareholder support in 2007 with almost 29 percent of votes cast supporting such proposals. *Id.* In 2008, only 10.7 percent of votes cast supported such proposals. *Id.* With respect to shareholder proposals seeking to strengthen existing clawback provisions, corporations often seek to exclude such proposals from shareholder consideration on the basis that the company has "substantially implemented" the proposal. *See* 17 C.F.R. § 240.14a-8(i)(10) (2006). However, the Securities and Exchange Commission has permitted companies to exclude such proposals only in cases where the proposal closely corresponds to existing clawback provisions. *See* CLAWBACKS OF EXECUTIVE COMPENSATIONS, *supra* note 65. In the case of participants in the TARP program, it is likely that shareholder proposals to implement executive compensation policies will be subject to such challenges. *See* Letter from Regions Financial Corp. to the Securities and Exchange Commission, Omission of Shareholder Proposal Pursuant to Rule 14a-8 (Dec. 19, 2008), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/columbosheetmetal121908-14a8-incoming.pdf>. Shareholder proposals that contain clawback provisions that may be difficult to interpret and implement may also be challenged by the issuer on the grounds that such proposals are misleading because they are too vague and indefinite. *See* 17 C.F.R. § 240.14a-8(i)(3) (2006); Verizon Communications, Inc., SEC No-Action Letter, 2008 SEC No-Act LEXIS 299 (Feb. 21, 2008); General Electric Co., SEC No-Action Letter, 2003 SEC No-Act LEXIS 190 (Feb. 5, 2003).

prevent excessive risk taking and an undue focus on short-term results. On the other hand, corporations must consider the possibility that draconian clawback provisions will stifle prudent risk taking and hamper the corporate recruitment of new talent and the retention of existing talent. Companies must decide to whom the clawback provisions will apply. Limiting such provisions to those executives covered by Section 304 of the Sarbanes-Oxley Act of 2002 will, for most companies, prove under-inclusive because it is likely that many more employees will be entitled to performance-based compensation and will have performed functions that the clawback provisions are designed to regulate.<sup>70</sup> Provisions triggered by accounting restatements should be, in all fairness, implemented to apply to any employee whose compensation was based on erroneous figures.

A significant issue in the drafting of clawback policies is whether such policies are triggered by misconduct of the employee or are of a “no-fault” variety. In the event that the trigger is misconduct, the types of actions—or lack thereof—that constitute misconduct need to be expressed.<sup>71</sup> Equitable considerations appear to favor no-fault policies

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70. A number of prominent corporations have adopted clawback provisions with extremely limited coverage. See, e.g., Microsoft Corp., Schedule 14A, Proxy Statement Filed Pursuant to Section 14(a) of the Securities Exchange Act of 1934 at 24 (Sep. 29, 2008) [*hereinafter* Microsoft Proxy Statement], available at <http://www.sec.gov/Archives/edgar/data/789019/000119312508203233/ddef14a.htm> (applying clawback provisions to executive officers and the principal accounting officer); Qwest Communications International, Inc., Schedule 14A, Proxy Statement Filed Pursuant to Section 14(a) of the Securities Exchange Act of 1934 at 36-37 (March 18, 2009) [*hereinafter* Qwest Communications Proxy Statement], available at [http://www.sec.gov/Archives/edgar/data/1037949/000104746909002842/a2191552zdef14a.htm#du12401\\_equity\\_compensation\\_plan\\_information](http://www.sec.gov/Archives/edgar/data/1037949/000104746909002842/a2191552zdef14a.htm#du12401_equity_compensation_plan_information) (applying clawback provisions to executives).

71. Among the issues that should be addressed is what level of participation is required by the employee in the improper accounting. For example, misconduct could be defined as direct participation with the intent to prepare false information, or it could be defined to include negligence in failing to detect inaccuracies and numerous variations in between these two standards. Several prominent corporations have adopted clawback policies triggered by fraud or other forms of misconduct. See, e.g., Verizon Communications Inc. Schedule 14A, Proxy Statement Filed Pursuant to Section 14(a) of the Securities Exchange Act of 1934 at 39 (March 23, 2009), available at [http://www.sec.gov/Archives/edgar/data/732712/000119312509060836/ddef14a.htm#toc95746\\_21](http://www.sec.gov/Archives/edgar/data/732712/000119312509060836/ddef14a.htm#toc95746_21); Microsoft Proxy Statement, *supra* note 70, at 24; General Electric Co., Schedule 14A, Proxy Statement Filed Pursuant to Section 14(a) of the Securities Exchange Act of 1934, at 22 (March 3, 2009), available at [http://www.sec.gov/Archives/edgar/data/40545/000119312509031738/ddef14a.htm#tx96252\\_2](http://www.sec.gov/Archives/edgar/data/40545/000119312509031738/ddef14a.htm#tx96252_2). Qwest Communications considers misconduct as one factor in the decision to exercise a clawback. Qwest Communications Proxy Statement, *supra* note 64, at 36-37. The company has, however, adopted a much broader clawback policy with respect to executive severance payments. *Id.* at 51 (subjecting severance payments to clawback due to, *inter alia*, acts involving moral turpitude, the conviction of a crime, and actions that reflect negatively on the company). In contrast, Pfizer, Inc. has adopted a clawback policy that is not predicated on misconduct. See Pfizer, Inc., Schedule 14A, Proxy Statement Filed Pursuant to Section 14(a) of the

when dealing with compensation measured by specific performance metrics that, in hindsight, due to misstatements, were not met. However, such no-fault provisions will likely prove extremely unpopular with employees and could hamper employee recruitment and retention efforts. The scope of the clawback provisions is another important consideration in drafting such provisions. Section 304 of the Sarbanes-Oxley Act of 2002 is relatively broad in scope, encompassing both incentive compensation and profits from the sale of securities.<sup>72</sup> TARP recipients, although not obligated to return profits from the sale of securities, are also subject to broad clawback provisions that include retention bonuses within their reach.<sup>73</sup> An additional consideration is the timeframe under which such provisions operate.<sup>74</sup> Section 304 of the Sarbanes-Oxley Act of 2002 provides a relatively modest twelve-month timeframe whereas the TARP legislation provides no such limit.<sup>75</sup> It appears that clawback time frames can be comfortably extended to the extent that the clawback would result in the forfeiture of compensation accrued, but not yet paid. For example, many companies, in light of the criticisms directed at bonuses based on short-term results, have instituted long-term holding requirements for equity awards granted to executives.

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Securities Exchange Act of 1934 at 60 (March 12, 2009), available at [http://www.sec.gov/Archives/edgar/data/78003/000119312509053142/ddef14a.htm#toc58878\\_47](http://www.sec.gov/Archives/edgar/data/78003/000119312509053142/ddef14a.htm#toc58878_47).

72. See *supra* note 38 and accompanying text. The Sarbanes-Oxley Act of 2002 does not apply to the profit made through the exercise of stock options. See *supra* note 37 and accompanying text.

73. See *supra* note 55 and accompanying text. It is extremely rare for clawback policies to reach qualified-pension and profit-sharing-plan income subject to the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (1974). This legislation contains anti-forfeiture provisions that would inoculate vested benefits from clawback provisions. However, it is possible for such provisions to reach non-vested benefits. See *generally* Clark v. Lauren Young Tire Center Profit Sharing Trust, 816 F.2d 480 (9th Cir. 1987). However, because such plans are subject to strict limitations on benefits targeted at high income employees, such income is a relatively small portion of executive compensation. Certain types of plans are not covered by ERISA's anti-forfeiture rules. These plans are designed to supplement the qualified plan benefits of top management and highly compensated employees. A discussion of ERISA is well beyond the scope of this work. For a general overview of this legislation see PAUL J. SCHNEIDER & BRIAN M. PINHEIRO, ERISA: A COMPREHENSIVE GUIDE (3d ed. 2007).

74. Retroactive application of clawback provisions raises a number of enforcement issues. For example, such provisions may violate the express terms of existing contracts and, to the extent that they do not, may be unenforceable due to a lack of consideration. Of course, in cases where federal law provides for the clawback of compensation, such clawback will withstand any state law contractual claim to the contrary. U.S. CONST. art. VI, § 2. Companies that have instituted clawback provisions need to exercise care in executing severance or termination arrangements with employees. Oftentimes such arrangements come with a reciprocal release of claims by the parties. A release of claims by the company may, if not carefully avoided, encompass any claim to compensation pursuant to a clawback provision.

75. See *supra* notes 34-39 and accompanying text.

These policies, termed “hold til (or through) retirement” requirements, mandate that a portion of equity awards be held until, or through, retirement.<sup>76</sup> A relatively long timeframe for which such awards are subject to clawback should meet less employee resistance than policies that reach back and require repayment of compensation for which the recipients had unfettered use.

Finally, careful consideration should be given to whether the board of directors should be given discretion in applying clawback provisions. Board discretion offers companies the ability to exercise such provisions as particular circumstances warrant.<sup>77</sup> However, board discretion is likely to call into question the firm’s commitment to the instituted policies and perhaps raise the ire of shareholders.<sup>78</sup> Discretionary clawbacks may also be subject to challenge under state wage-payment laws.<sup>79</sup> Although such laws vary from state to state, incentive compensation often—but not always—falls outside the scope of wage-payment laws.<sup>80</sup> Clearly expressed contractual rights to clawback incentive compensation based on objective standards should also prevent clawbacks from running afoul of state law in states where the incentive compensation is subject to the statutory provisions in question.<sup>81</sup>

76. The TARP legislation institutes a variant of this type of restriction with respect to incentive compensation. *See supra* note 58 and accompanying text.

77. Qwest Communications International, Inc. has incorporated significant board discretion in its clawback policies. In the event of an accounting restatement that resulted in the improper payment to an executive then such compensation may be clawed back if the board decides “it is in our best interests to recover the performance-based compensation paid to that executive . . . .” Qwest Communications Proxy Statement, *supra* note 70, at 37.

78. Provisions granting the board discretion are likely to generate shareholder proposals for tougher provisions. It is unlikely that the Securities and Exchange Commission will grant management the right to exclude such proposals from a shareholder vote. *See supra* note 69 and accompanying text.

79. State wage-payment laws were enacted to prevent employers from avoiding their obligations under, *inter alia*, collective bargaining agreements and minimum-wage statutes. California’s statute, for example, provides that “[i]t shall be unlawful for any employer to collect or receive from any employee any part of wages theretofore paid by said employer to said employee.” CAL LAB. C. § 221 (2009).

80. *See, e.g.*, *Int’l Bus. Machines Corp. v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (holding that stock options were not wages for purposes of the California wage payment law); *Int’l Paper Co. v. Suwyn*, 978 F. Supp. 506 (S.D.N.Y. 1997) (holding that incentive compensation dependent upon the financial results of the employer are not wages for purposes of New York’s wage-payment statute). A clawback cannot cause an employee’s compensation to fall below federal or state minimum wage levels—an unlikely event with respect to executive compensation. *Id.* at 514.

81. Pennsylvania law, for example, includes incentive compensation within the scope of its wage payment law. *See Hartman v. Baker*, 766 A.2d 347 (Pa. Super. 2000). Wage-payment laws do not, however, create an entitlement to compensation. The compensation must be earned or vested under the terms of the contract. Therefore, a clawback trigger that is clear and unambiguous will more likely withstand a claim that the compensation in question was earned or vested and thus

The enforcement of clawback provisions raises a number of federal income tax issues for the executives that are subject to these provisions. The tax consequences in the year the compensation is clawed back depend on various factors, including whether the compensation in question had been paid to the executive, the nature of the compensation clawed back, the executive's particular tax circumstances, and the reason for the clawback. In many respects, federal income tax law will treat such executives harshly – a perverse form of poetic justice. Executives will often find that the forfeiture of unpaid and heretofore untaxed compensation is preferable than the repayment of previously taxed income.

### III. FEDERAL INCOME TAX IMPLICATIONS OF COMPENSATION CLAWBACKS

Intuitively, the repayment or forfeiture of compensation that had been subject to tax in an earlier tax year should result in a tax benefit commensurate with the tax burden imposed on the compensation in the year it was taxed. However, the annual accounting principle virtually assures that this is not the case. This principle spawned the judicially created “claim of right” doctrine pursuant to which income that may be later forfeited or disgorged is nonetheless subject to tax in the year of its receipt.<sup>82</sup> Correspondingly, the repayment of compensation will yield a deduction in the year of repayment.<sup>83</sup> Due to the peculiarities of the Internal Revenue Code, it is likely that such deduction will fail to yield a tax benefit commensurate with the tax burden imposed upon the income. In the event that the taxpayer fails to recoup the taxes originally imposed on the compensation in question, Internal Revenue Code Section 1341 provides relief if the taxpayer has the fortune to qualify under its provisions. This part provides an analysis of the annual accounting principle, the claim-of-right doctrine, and Section 1341. In addition, because the tax consequences of compensation clawbacks depend, in large part, on the taxation of the income that is clawed back, the taxation

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subject to the wage payment law. *See, e.g., Doe v. Kohn, Nast & Graf, P.C.*, 862 F. Supp. 1310, 1325 (E.D. Pa. 1994); *Redick v. Kraft, Inc.*, 745 F. Supp. 296, 303 (E.D. Pa. 1990). In *Kafando v. Erie Ceramic Arts Co.*, 764 A.2d 59 (Pa. Super. 2000), the court held that bonuses based on the employer's gross profit ratio were not wages under the Pennsylvania wage-payment statute. *Id.* at 62. The court based its holding on the fact that such earnings were not based upon an employee's time or task. *Id.* It is unlikely that such a rationale would support the exclusion of incentive compensation for executives.

82. *North Am. Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

83. 26 U.S.C. § 1341 (2006).

of various forms of incentive compensation is discussed. Finally, an analysis of the tax treatment of clawbacks under a myriad of circumstances is provided.

#### *A. Annual Accounting Principle*

Practical considerations dictate that taxpayers' obligations to the United States Treasury be determined at some pre-defined interval.<sup>84</sup> In the seminal case of *Burnet v. Sanford and Brooks Co.*, the Supreme Court stated that:

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.<sup>85</sup>

U.S. income taxes are determined on the basis of an annual accounting period. I.R.C. section 441(a) states, "[t]axable income shall be computed on the basis of the taxpayer's taxable year."<sup>86</sup> In most cases, a taxpayer's taxable year will encompass a period of twelve calendar months.<sup>87</sup> The annual accounting concept is an artifice borne out of administrative convenience. Due to the all too numerous idiosyncrasies of the Internal Revenue Code, the segmentation of a taxpayer's tax obligations into annual compartments virtually assures that two taxpayers with identical incomes over an extended period of time will incur different tax obligations. For example, progressive tax rates may cause the taxpayer whose income is subject to peaks and valleys to bear a greater tax burden than the taxpayer earning identical

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84. The annual accounting system is "a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals." *Hillsboro Nat'l. Bank v. Comm'r*, 460 U.S. 370, 377 (1983).

85. 282 U.S. 359, 365 (1931).

86. There are various references in the Internal Revenue Code to the taxable year. *See, e.g.*, I.R.C. §§ 11 (2006) (imposing tax on corporations for each taxable year); 6012 (2006) (requiring the filing of income tax returns of individuals and certain entities that exceed certain income thresholds during the taxable year).

87. *See* I.R.C. § 441(d)-(e) (2006). Taxpayers may elect, under certain circumstances, a 52-53 week taxable year that ends on the same day of week. *See* I.R.C. § 441(f) (2006). Accounting periods of less than twelve months may result from a change in accounting period or in cases where the taxpayer has not been existence for twelve months. *See* I.R.C. § 443(a) (2006). Individuals, with rare exceptions, determine their income on a calendar year basis. Partnerships, S-corporations, and personal service corporations have limited flexibility in the selection of their taxable years. *See generally* I.R.C. §§ 441(i); 444; 706(b); 1378 (2006).

amounts at a steadier pace.<sup>88</sup> Likewise, a taxpayer who realizes capital losses in some years and capital gains in other years is likely to be disadvantaged when compared to a taxpayer who fortuitously realizes losses during the same year that gains were realized.<sup>89</sup> The current economic predicament in which we find ourselves has brought to light the tax disadvantages of earning large amounts of income over many years, followed by a year or two of extraordinarily large losses—a situation that recent legislation has attempted to ameliorate.<sup>90</sup>

The centrality of the annual accounting principle is evidenced by the federal income tax treatment of transactions that are subsequently rescinded.<sup>91</sup> Rescission may be effectuated pursuant to contract

88. Taxpayers who enjoy a few years of very high earnings may be at an advantage with respect to payroll taxes, specifically old-age, survivors, and disability income tax obligations. Such obligations are limited to certain income thresholds that are adjusted annually for inflation. *See generally* I.R.C. §§ 3101(a); 3121(a)(1) (2006).

89. I.R.C. § 1211(a) limits corporations from deducting capital losses in excess of capital gains, and I.R.C. § 1211(b) limits non-corporate taxpayers to deductible capital losses of \$3,000 in excess of capital gains. Corporate capital losses may, in general, be carried back three years and forward five years. I.R.C. §§ 1212(a)(1)(A), 1212(a)(1)(B). Other taxpayers may carry forward unused losses indefinitely, subject to the aforementioned \$3,000 limitation. *See* I.R.C. § 1212(b) (2006).

90. In general, net operating losses incurred in a taxable year may be carried back two years and forward twenty years to offset taxable income in the year to which such losses are carried. 26 U.S.C.A. § 172(a)-(b)(1) (West 2009). An elective carry-back period, up to a maximum of five years, has been provided for certain small businesses by the recently enacted stimulus legislation. *American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, § 1211, 123 Stat. 335 (2009) (codified at 26 U.S.C. § 172(b)(1)(I)(i)). The value of unused net operating losses are often a significant asset of companies targeted by suitors. See, e.g., Jesse Drucker & Matthew Karnitschnig, The Lure of Sirius: Tax Losses, WALL ST. J., Feb. 21, 2009, at B1 (discussing the interest of suitors in Sirius XM Radio). Significant limitations are imposed on the ability to acquiring corporations to use net operating losses generated by acquired corporations. See generally I.R.C. § 382 (2006) (limiting the annual use of acquired net operating losses to the value of the acquired corporation multiplied by an I.R.S. provided interest rate). The I.R.S. eased these rules temporarily in late 2008 for acquisitions in the financial sector. See Notice 2008-83, 2008-42 I.R.B. 905 (Oct. 20, 2008). Whether the Internal Revenue Service had the authority to grant such relief has been subject to considerable debate. See, e.g., Lawrence Zelenak, Can Obama's IRS Retroactively Revoke Massive Bank Giveaway?, TAX NOTES, February 16, 2009, at 889. The American Recovery and Reinvestment Tax Act of 2009 terminated this relief effective for ownership changes occurring after January 16, 2009. Pub. L. No. 111-5, § 1261, 123 Stat. 342-43 (2009).*

91. Rescission is the voiding of a contract *ab initio*. Rescission is often confused with the abandonment of a contract. However, abandonment of a contract discharges the injured party's obligation to perform under the contract but, for purposes of supporting a remedial right to damages, the contract remains alive. *See* 17A AM. JUR. 2D *Contracts* § 528 (2009). A contract may also be rescinded unilaterally by a party to the contract due to the existence of some legally sufficient grounds such as mistake, duress, fraud, and the like. *See* 17A AM. JUR. 2D *Contracts* § 549 (2009). Generally, a contract must be rescinded in total, but partial rescission may be allowed if the contract in question is divisible. *See* 17A AM. JUR. 2D *Contracts* § 533 (2009). A party may not seek



provisions or may occur as a result of a court decree.<sup>92</sup> Transactions may be rescinded for a number of reasons. For example, a transaction that results in the issuance of corporate securities may be rescinded if the issuance of securities jeopardizes the tax status of the issuer. The conversion of a limited liability company or partnership into a corporation in anticipation of an initial public offering may be unwound if the initial public offering is shelved.<sup>93</sup> Rescission may also be sought as a remedy in an adversarial proceeding. In *Penn v. Robertson*,<sup>94</sup> executives of the American Tobacco Company participated in a stock purchase program under which the participants were able to purchase stock in the company at prices below the stock's fair market value. The employees issued notes in payment for the stock, and the program anticipated that the notes would be repaid from dividends and bonuses the participants were to receive from the company.<sup>95</sup> In the year subsequent to the institution of the program, the entire arrangement was rescinded in response to shareholder lawsuits alleging that the plan was not duly authorized.<sup>96</sup> The Fourth Circuit held that the income received by the executives under the program in the year prior to rescission was properly reported in that year.<sup>97</sup> The income received in the year of rescission and paid back to the company was not reportable as income, however.<sup>98</sup>

The Internal Revenue Service has ruled that transactions will be disregarded for tax purposes if the transaction is rescinded during the same taxable year and the parties are returned to the status quo ante.<sup>99</sup>

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rescission and damages for breach although such remedies may be alternatively pleaded. *See generally* 25 AM. JUR. 2D *Election of Remedies* § 25 (2009).

92. *Id.*

93. The issuance of certain types of securities may cause the termination of a corporation's election to be taxed as an S-corporation. *See* I.R.C. § 1361(b) (2006). Publicly traded partnerships, with certain exceptions, are taxed as corporations. Absent an election to be taxed as a corporation, limited liability companies are taxed as partnerships. Consequently, from a tax standpoint, there is little to be gained by retaining the partnership or limited liability company form if the entity's ownership interests are publicly traded. *See generally* I.R.C. § 7704 (2006); Treas. Reg. § 301.7701-3(b)(i) (2006). *See also* I.R.S. Priv. Ltr. Rul. 2006-13-027 (March 31, 2006); I.R.S. Priv. Ltr. Rul. 2005-33-002 (Aug. 19, 2005).

94. 115 F.2d 167 (4th Cir. 1940).

95. *Id.* at 170.

96. *Id.* at 171.

97. *Id.* at 174-75.

98. *Id.* at 175-76.

99. Rev. Rul. 80-58, 1980-1 C.B. 181. Section 1(b)(2)(C) of H.R. 1586, discussed *supra* note 25, created a legislative version of the rescission doctrine. The 90 percent tax imposed on disqualified bonus payments would not have applied to bonus payments that were returned by the employee before the close of the taxable year. *Id.*

Consequently, transactions rescinded in a later year will not disturb the tax consequences reported in tax years prior to the rescission.<sup>100</sup> The rescission doctrine has limited applicability to compensation clawbacks. Typically, clawbacks do not arise from the rescission of a contract. To the contrary, clawbacks may be triggered under the terms of the contract. *Penn v. Robertson* may provide support for the position that compensation that is returned in the same year that it was received need not be reported as income.<sup>101</sup> However, it is unlikely such situations will arise with regularity.

In addition to the tax disparities that result from the timing of income that is earned over an extended period, the annual accounting concept can also create anomalies on a transactional basis. Quite often, the profitability of routine transactions cannot be determined with certainty during a taxable year.<sup>102</sup> For example, the ultimate profitability of a sales transaction will not be known until the receivable generated by the sale is collected or the warranty period applicable to the item sold has expired.<sup>103</sup> Cash-method taxpayers must recognize prepaid income at the time of its receipt despite the fact that the taxpayer is obligated to render services in a subsequent taxable year.<sup>104</sup> In certain cases, the statutes or regulations attempt to approximate the results that would be attained in a transactional accounting system.<sup>105</sup> In extremely rare

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100. See I.R.S. Priv. Ltr. Rul. 93-41-010 (Oct. 15, 1993).

101. See *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940).

102. See *infra* note 103 and accompanying text.

103. Certain accrual-basis taxpayers doing business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting do not need to accrue income that, on the basis of past experience, will not be collected. I.R.C. § 448(d)(3) (2006). Banks and certain other financial institutions are permitted to reserve for loan losses. See I.R.C. §§ 585; 593 (2006).

104. Accrual-basis taxpayers may also be required to report prepaid income in the year of receipt. However, several exceptions are available to accrual-basis taxpayers that prevent this result. See *generally* Treas. Reg. § 1.451-5 (2001) (providing an exception for advance payments for goods); Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (June 1, 2004) (modifying and superseding Rev. Proc. 71-21, 1971-2 C.B. 549 to expand the scope of transactions for which taxpayers may defer income from advance payments for services).

105. For example, regulations that implement the installment sales rules of I.R.C. § 453A contain detailed provisions that govern the accounting of installment sales with contingent sales prices. These regulations require the taxpayer's basis in the property sold to be recovered under various methods depending on whether a maximum sales price is stated, a fixed period of time is stated, or whether neither a maximum price nor fixed period time is provided. In a similar vein, an elaborate set of rules has been promulgated to deal with debt instruments with contingent interest under the original issue discount rules. See *generally* Treas. Reg. §§ 1.453A-1(c) (1994); 1.1275-4 (2004). Taxpayers accounting for long-term contracts under the percentage of completion method may be required to pay interest if, after the contract is completed and all costs are known, the taxpayer's estimates of the percentage of the contract completed throughout the years was too low,

circumstances, a taxpayer may keep a transaction open until it is completed.<sup>106</sup>

## B. Claim of Right Doctrine

### 1. Income Inclusion

The need to keep faith with the annual accounting concept led to the judicially created claim-of-right of doctrine. This doctrine requires a taxpayer to recognize income received under a claim of right despite the fact that taxpayer may be obligated to return such income in the future.<sup>107</sup> This doctrine is founded on the premise that income must be

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thereby resulting in a deferral of tax. *See generally* I.R.C. § 460(b)(2) (2006). The aforementioned rules are not meant to be exhaustive, but merely indicative of the Internal Revenue Service's willingness to engage in transactional accounting when it believes the annual accounting system provides taxpayers with an easy avenue to tax deferral. On occasion, however, transactional type accounting does benefit taxpayers. *See supra* note 103 (noting that certain accrual basis taxpayers do not have to accrue income for services that, based on experience, will go uncollected).

106. The open-transaction doctrine causes the tax consequences of a transaction to remain open until subsequent events materialize that allow for the determination of the income generated from the transaction. This doctrine has its most singular applicability in the context of contingent sales transactions. The open-transaction doctrine had its genesis in the landmark case of *Burnet v. Logan*, 283 U.S. 404 (1931). In general, income from an open transaction will not be recognized until such time as the proceeds received exceed the taxpayer's basis in the property. The Internal Revenue Service strongly resists the application of this doctrine and, over the years, has substantially diminished its availability. For example, in the case of an installment sale with a contingent sales price, the lack of a maximum sales price or fixed period of time under which payments are to be received raises factual questions as to whether a sale has, in fact, occurred. If, after considering all the facts and circumstances, a sale has indeed occurred, then the taxpayer will recover her tax basis over a fifteen-year period. *See* Treas. Reg. § 15A.453-1(c)(4) (1994). In the event that the sale is not subject to installment reporting, the Internal Revenue Service has made clear that open-transaction treatment is reserved for "those rare and extraordinary cases in which the fair market value of the obligation cannot reasonably be ascertained." Treas. Reg. § 15A.453-1(d)(2)(iii) (1994). One commentator believes that the open transaction doctrine spawned the *Arrowsmith* doctrine that is discussed at *infra* notes 153-164 and accompanying text. *See* Myron C. Grauer, *The Supreme Court's Approach to Annual and Transactional Accounting for Income Taxes: A Common Law Malfunction in a Statutory System?*, 21 GA. L. REV. 329, 357-58 (1986). Ironically, the current tax treatment of nonqualified stock options bears a strong resemblance to the open transaction doctrine. In essence, the incidence of taxation is postponed from the date the options are granted until the date such options are exercised. There is no principled reason why such options cannot be valued at the date of grant. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (presenting the Black-Scholes model); JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES*, 194-207 (4th ed. 2000) (discussing the binomial option pricing model). *See also infra* note 251 (citing to the recently issued accounting standard that mandates the expensing of compensatory options at the time of grant). For a discussion of the tax treatment of compensatory stock options *see infra* notes 252-254 and accompanying text.

107. *See infra* note 109.

determined at the close of a taxable year and that subsequent events are disregarded.<sup>108</sup> The claim-of-right doctrine was established in the seminal case of *North American Oil Consolidated Co. v. Burnet*.<sup>109</sup> In that case, the taxpayer and the United States were embroiled in a dispute regarding beneficial ownership and income from an oil field that the taxpayer operated, but in which the government held legal title.<sup>110</sup> A receiver was appointed in 1916 to operate the property and hold the income derived there from.<sup>111</sup> A district court, in 1917, held in favor of the taxpayer and the receiver thereby turned over the income to the taxpayer in that year.<sup>112</sup> The government appealed and the district court's decision was affirmed in 1920.<sup>113</sup> Certiorari was denied in 1922. The taxpayer asserted that the income received in 1917 was taxable in 1922, the year all litigation over the income terminated.<sup>114</sup> The Internal Revenue Service argued that the income was taxable in 1917, the year the taxpayer received the income.<sup>115</sup> The Supreme Court, holding for the government, stated that:

[I]f a taxpayer received income under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not

108. The irrelevance of subsequent events is premised on both doctrinal and practical considerations. Doctrinally, the fact that the taxpayer has actual command over the property taxed provides justification for taxation at that time. *United States v. Lewis*, 340 U.S. 590, 591 (1951). In addition, disregard of subsequent events avoids the administration burdens that would be imposed upon the Internal Revenue Service if it had to determine the merits of taxpayers' claims. *See United States v. Merrill*, 211 F.2d 297, 304 (9th Cir. 1954).

109. 286 U.S. 417 (1932). The Court held that the claim-of-right doctrine applied regardless of whether the taxpayer utilized the cash or accrual method of accounting. *Id.* at 423. The only discernable difference in the application of the claim-of-right doctrine to cash- and accrual-basis taxpayers appears to be the timing of the deduction in the event the income is required to be repaid. Accrual-basis taxpayers are entitled to deduct the repaid income in the year it is properly accruable under general tax accounting principles. The term "claim of right" was actually coined in an earlier Sixth Circuit case. *See Board v. Comm'r*, 51 F.2d 73, 75 (6th Cir. 1931).

110. *N. Am. Oil Consol.*, 286 U.S. at 420.

111. *Id.* at 421.

112. *Id.*

113. *Id.*

114. *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 420 (1932).

115. All references to the Internal Revenue Service include references to the Bureau of Internal Revenue, the former name of the agency. The official name of the agency was changed to the Internal Revenue Service in 1953. *See* T.D. 6038, 1953-2 C.B. 443. The taxpayer argued that the income was taxable either in 1916, the year the income was earned but retained by the receiver, or in 1922, the year all litigation terminated. *N. Am. Oil Consol.*, 286 U.S. at 422. The Court held that the income was not taxable in 1916 because the taxpayer had not received the income in that year. *Id.* at 423. It appears that the taxpayer was willing to incur tax on the income in 1916 because tax rates were lower in 1916 than they were in 1917. *See Grauer, supra* note 106, at 351 n.65 (citing M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* ¶10.02, at 205).

entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.<sup>116</sup>

In dicta, the Court stated that had the taxpayer been obliged to return the income, it would have been entitled to a deduction in the year the profits were returned and would not be entitled to amend a previous year's return.<sup>117</sup> The Court had occasion to revisit this issue in *United States v. Lewis*.<sup>118</sup> In this case the taxpayer received a bonus in 1944.<sup>119</sup> Two years later, the taxpayer, as a result of litigation, was required to repay approximately one-half of the bonus to his employer.<sup>120</sup> The taxpayer sought a refund of taxes that he paid in 1944 but the Internal Revenue Service contended that the repayment of the bonus was deductible as a loss in 1946, the year it was repaid.<sup>121</sup> The Court, citing *North American Oil*, held for the government.<sup>122</sup> Interestingly, the Court had the opportunity to create an exception to the claim-of-right doctrine for cases in which the statute of limitations for amending returns had not run. In this case, the taxpayer had the ability to file an amended return. The Court chose not to create such an exception.<sup>123</sup> The Supreme Court and lower courts have reaffirmed the claim-of-right doctrine on several occasions and it "has become a firmly established principle of federal income taxation."<sup>124</sup>

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116. *N. Am. Oil Consol.*, 286 U.S. at 424. This doctrine requires that amounts be received under a claim of right. The taxpayer must treat the income as hers. Therefore, the doctrine does not apply to customer or client overpayments that are reflected as liabilities on the books of the taxpayer. The doctrine does apply, however, to funds received by mistake, embezzlement, violation of fiduciary duties, and breach of contract. See JAMES E. MAULE, GROSS INCOME: TAX BENEFIT, CLAIM OF RIGHT AND ASSIGNMENT OF INCOME, 502-3rd TAX MGMT. (BNA 2007) A-26 - A-29. The doctrine has not been applied to prepaid income. *Id.* at A-25. The taxation of prepaid income is guided by general tax accounting principles and specific guidance has been issued by the Internal Revenue Service with respect to such income. See *supra* note 104 and accompanying text.

117. *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

118. 340 U.S. 590 (1951).

119. *Id.* at 590.

120. *Id.*

121. *Id.* at 591.

122. *Id.* at 591-92.

123. Justice Douglas would have created such an exception. *United States v. Lewis*, 340 U.S. 590, 592 (1951) (Douglas, J., dissenting).

124. MAULE, *supra* note 116, at A-23. More than three-quarters of a century after its arrival, the precise contours of this doctrine are not entirely clear. Commentators disagree whether the doctrine is a tax accounting concept, created solely for the purpose of determining when income is subject to tax, or a substantive rule of law that defines taxable income. The Supreme Court declined to opine on this issue. See *James v. United States*, 366 U.S. 213, 216 n.7 (1961). Moreover, the requirement that income be received under "claim of right" has been ignored in the case of ill-gotten income. It is well-settled that funds obtained through embezzlement or theft are taxable under this doctrine in the year of receipt, despite the fact that the wrongdoer has no cognizable claim to the funds. See, e.g., *id.* at 219; *Rutkin v. United States*, 343 U.S. 130, 137 (1952). The Bernard Madoff

The Ninth Circuit, in *United States v. Merrill*,<sup>125</sup> created a limited exception to the application of the claim-of-right doctrine. In that case, a cash-method taxpayer erroneously received executor fees, discovered the mistake in the year such fees were received, and acknowledged his obligation to repay the fees.<sup>126</sup> However, the fees were repaid in a later year.<sup>127</sup> The court held that the erroneous fees were not income in the year of receipt and noted that the “harsh claim of right doctrine” should not apply to taxpayers who, acting in good faith, acknowledge their obligation to repay amounts in the year such amounts are received.<sup>128</sup> The courts have generally limited the *Merrill* exception to situations where the obligation to repay is unconditional, and the funds in question were obtained by virtue of a mistake, as opposed to wrongdoing.<sup>129</sup> The Seventh Circuit has refused to apply the *Merrill* exception on the grounds that *Merrill* predated the enactment of Section 1341, a provision

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scandal raises some interesting issues with respect to application of this doctrine. Taxpayers who actually received funds from Madoff that are required to be returned arguably will be ensnared by the doctrine and will have to settle for deducting any repayments made in the year of repayment. Investors who did not actually receive the phantom income that Madoff claimed to have generated may be able to file amended returns for the years in which the statute of limitations has not run. However, if the income that was reported to investors was subject to withdrawal by the investors then, quite possibly, they were in constructive receipt of the income and the claim-of-right doctrine may very well apply. Until more facts come to light regarding Madoff’s Ponzi scheme it is difficult to draw conclusions as to the possible tax consequences for defrauded investors. The I.R.S. has issued very favorable guidance with respect to the tax treatment of these losses. The I.R.S. has ruled that losses incurred by investors are to be treated as theft losses related to a transaction entered into for profit. Consequently, the loss is not subject to the 10 percent of adjusted gross income reduction nor the per occurrence floor applicable to casualty and theft losses. Moreover, such losses are not subject to the 2 percent floor on miscellaneous itemized deductions nor to the I.R.C. § 68 overall limitation on such deductions. Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (March 17, 2009). The I.R.S. has also provided safe harbors for determining the amount of the deduction. The safe harbor applies only to investors who invested directly in the Ponzi scheme and not to those investors who invested in the scheme indirectly—for example, through a fund of funds investment. Investors not pursuing a recovery of funds from a third party may deduct 95 percent of their losses less any recoveries from insurance providers or the Securities Investor Protection Corporation. Investors pursuing claims against third parties may deduct 75 percent of their losses. Rev. Proc. 2009-20, 2009-14 I.R.B. 749 (March 17, 2009). For an excellent analysis of the inconsistencies in the application of the claim-of-right doctrine - and the exceptions thereto—see Harold Dubroff, *The Claim-of-right doctrine*, 40 TAX L. REV. 729, 738-47 (1985).

125. 211 F. 2d 297 (9th Cir. 1954).

126. *Id.* at 298-99.

127. *Id.* at 302.

128. *Id.* at 304.

129. See *Hope v. Comm’r*, 471 F.2d 738, 742 (3d Cir. 1973); *Buff v. Comm’r*, 496 F. 2d 847, 848 (2d Cir. 1974).

intended to ameliorate the inequities that may result from the application of the claim of right doctrine.<sup>130</sup>

The claim-of-right doctrine will prevent taxpayers whose income is clawed back from amending prior years' income tax returns. Any tax benefits that result from the repayment or forfeiture of compensation will be limited to those generated by a tax deduction in the year such compensation is repaid or forfeited.

## 2. Deductibility of Repayments

### a. In General

The corollary to the recognition of income received under a claim of right is the deduction of the repayment of such income in a subsequent tax year. Subject to various exceptions, the tax code limits deductions to expenditures or losses incurred in a trade or business or in connection with an activity entered into for profit. Section 162(a) states that “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade or business . . . .”<sup>131</sup> In the case of individuals, losses are also deductible if such losses are incurred in a trade or business.<sup>132</sup> The distinction between an expense and a loss is not entirely clear, but whether a compensation repayment is classified as an expense or a loss should be of little practical consequence.<sup>133</sup> Whether a taxpayer is engaged in the carrying

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130. *Quinn v. Comm’r*, 524 F. 2d 617, 625 (7th Cir. 1975). Section 1341 was enacted in 1954. For a detailed analysis of this provision see *infra* notes 174-196 and accompanying text. The Seventh Circuit’s rationale appears harsh. Not all amounts received by cash basis taxpayers are income—cash advances under a credit card arrangement, for example. Likewise, if an individual mistakenly receives a payment that is clearly meant for another person and that fact is known to the recipient upon receipt then no income is realized. The fact that the recipient discovers the mistake in the same tax year, but not immediately upon receipt, hardly seems to justify treating the receipt of such funds as income. The rescission doctrine, discussed at *supra* notes 91-100 and accompanying text, requires the transaction and its rescission to occur in the same tax year. However, the circumstances to which *Merrill* putatively applies do not involve the unwinding of a contractual arrangement or legal status under which the recipient originally obtained the funds in question. *Id.*

131. I.R.C. § 162(a) (2006).

132. I.R.C. § 165(c)(1) (2006). A variety of expenses and losses are deductible that do not arise in a trade or a business or in activities carried on for profit. For example, interest expense on debt secured by a mortgage on a personal residence, state and local realty or income taxes, casualty and theft losses, charitable contributions, medical expenses, and alimony are deductible. *See, e.g.*, I.R.C. §§ 163(h)(2)(D); 164(a)(1)-(2); 165(c)(3); 170; 213; 215 (2006).

133. Most tax practitioners would classify expenditures made without a concomitant benefit or the disposition of property for less than its tax basis as losses. One court described the distinction between losses and expenses as “self-evident.” *Holt v. Comm’r*, 69 T.C.75, 78 (1977). However, it

on of a trade or business is a factual question. Trade or business status requires the existence of a profit motive and the engagement of regular and considerable levels of activity with respect to the enterprise.<sup>134</sup> The rendering of services as an employee is considered the carrying on of a trade or business.<sup>135</sup> Whether an expense is ordinary depends on the facts and circumstances and not whether an expense is recurrent in nature.<sup>136</sup>

An expenditure is deemed necessary if such expenditure is appropriate and helpful.<sup>137</sup> Thus, although an expenditure that is essential to the business would easily pass muster under this standard, deductibility does not turn on whether an expenditure is deemed essential.<sup>138</sup> It is not necessary for the expenditure to have been compelled, either contractually or otherwise, but voluntary expenditures have met with mixed results.<sup>139</sup> With respect to compensation repayments, whether such repayments are considered necessary appear to turn, in large part, on whether the repayments were compelled, by law

is often difficult to make a principled distinction between expenses and losses. See *Fed'n Bank & Trust Co. v. Comm'r*, 27 T.C. 960 (1975) (holding that a bank's payments to settle depositor claims were deductible as either expenses or losses).

134. See *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987). The issue of whether the taxpayer has a profit motive may be a significant issue for individual taxpayers. If the activity is found to lack a profit motive then deductions attributable to such an activity are limited to the gross income derived from the activity. These so-called hobby loss rules contain a presumption that an activity is engaged in for profit if the activity generates net income for a certain number of years in a defined testing period. See generally I.R.C. § 183 (2006).

135. Treas. Reg. § 1.162-17(a) (1990). A significant number of disputes arise over the status of investment activities. The Supreme Court, in *Higgins v. Commissioner*, 312 U.S. 212, 217-218, *reh'g denied*, 312 U.S. 714 (1941), held that the taxpayer's activities in managing a large securities portfolio did not rise to the level of a trade or business. The assets in question were financial assets that entitled the taxpayer to income but gave him neither the right to participate in managing the operations of a business nor any liability exposure beyond his investment. *Id.* at 215. Under *Higgins*, direct ownership of property, with its concomitant right to management and exposure to liability, is required for trade or business status. For example, real estate holdings may or may not represent a trade or business. Speculative holdings in raw land for eventual sale, rental real estate subject to long-term net leases, and royalty interests in natural resources, probably would not rise to the level of a trade or business. See *Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940); Rev. Rul. 73-522, 1973-2 C.B. 226 (1973).

136. See *Welch v. Helvering*, 290 U.S. 111 (1933). Generally speaking, if, under the circumstances, an expense would typically be incurred, it would be considered ordinary despite the fact that the circumstances surrounding the expenditure would not be expected to occur with regularity—law suits, for example.

137. See *id.* at 113.

138. See *infra* note 139.

139. Compare *Levy v. Comm'r*, 30 T.C. 1315 (1958) (holding that voluntary payments made by an agent to a performer were deductible) with *Friedman v. Delaney*, 171 F.2d 269 (1st Cir. 1948) (denying a deduction for voluntary payments made by an attorney to his clients to mitigate losses incurred partly as a result of the attorney's advice).



or agreement, or were voluntary.<sup>140</sup> In closely-held corporations, compensation repayments by shareholder-employees are not that unusual and are typically triggered by the Internal Revenue Service's assertion that the compensation in question was unreasonable and, therefore, not deductible.<sup>141</sup> In such circumstances, the employee is also a shareholder and the compensation may be repaid despite the fact that a clawback provision is absent from the employment contract and the corporate by-laws.<sup>142</sup> Voluntary repayments of this sort have also not fared well under Section 1341, discussed subsequently.<sup>143</sup>

If the expenditure or loss is incurred in connection with an activity that does not rise to the level of a trade or business, then an expense or loss deduction is nonetheless available if the expenditure was incurred for the production or collection of income or if the loss was incurred in an activity engaged in for profit.<sup>144</sup> Otherwise, no deduction is available unless the expense or loss falls within another statutory provision.<sup>145</sup>

The deductibility of amounts repaid may be denied if the amount originally received under a claim of right was not subject to tax. In general, this issue arises in cases where the amounts repaid were tax

140. See generally *United States v. Simon*, 281 F.2d 520, 526 (6th Cir. 1960); *Blanton v. Comm'r*, 46 T.C. 527 (1966), *aff'd. per curiam* 379 F.2d 558 (5th Cir. 1967); Rev. Rul. 69-115, 1969-1 C.B. 50.

141. Compensation is deductible to the extent it is reasonable. In closely held corporations high-ranking officers are typically shareholders. Excessive compensation may be re-characterized as a dividend for which no deduction is available to the corporation. See Treas. Reg. §§ 1.162-7(1958); 1.162-8 (1958). Consequently, the corporate by-laws or the terms of an employment agreement may require compensation, found by the Internal Revenue Service to be excessive, to be repaid. Similar requirements are also found with respect to compensation that may be classified as a golden parachute. Golden-parachute payments are payments made to officers, shareholders, or highly compensated employees made as a result of a change in control of the corporation and that exceed certain thresholds. Such payments are not deductible. See generally I.R.C. § 280G (2006).

142. Arguably, a voluntary repayment by employees in a publicly traded corporation made to retain employment would have a much better chance of meeting the "necessary" requirement than repayments made by employees who were also controlling shareholders of the employer. Several Nortel executives voluntarily repaid compensation after prior year earnings of the company were restated. See Anne Newman, *Giving Back the Bonus*, BUSINESS WEEK, Jan. 24, 2005, at 44.

143. See *infra* notes 174-196 and accompanying text.

144. See I.R.C. §§ 212(1); 165(c)(2) (2006). Section 212, like § 162, contains the "ordinary and necessary" requirement for deductible expenses. See *supra* note 131 and accompanying text. If the activity is found to lack a profit motive, then deductions attributable to the activity are limited to the gross income derived from the activity. These so-called hobby loss rules contain a presumption that an activity is engaged in for profit if the activity generates net income for a certain number of years in a defined testing period. See generally I.R.C. § 183 (2006).

145. Numerous deductions are allowed without regard to whether the expenditures or losses are incurred in a trade or business or in profit-making activity. Among the more common such items are mortgage interest, real estate and income taxes, casualty and theft losses, charitable contributions, and medical expenses. See generally I.R.C. §§ 163; 164; 165; 170; 213 (2006).

exempt, such as gifts<sup>146</sup> or the proceeds of a life insurance policy,<sup>147</sup> or in cases where the funds received were not reported as income—a not infrequent occurrence with respect to income from illegal activities. Various justifications for the denial of deductions for repayments of such amounts have been put forth, including consistency, equity, lack of tax basis, and tax-benefit analysis.<sup>148</sup> It is doubtful that this issue will regularly arise with respect to the repayment of compensation.<sup>149</sup> As subsequently discussed, forfeited compensation that was not previously includable in income typically will not implicate claim-of-right issues.<sup>150</sup> In such cases, the forfeited income was not realized and, therefore, was not income at all. Consequently, the forfeiture of such income is not a taxable event.

A related issue—the character of the deduction—is likely to arise with some regularity. It is quite possible that clawback provisions encompass any gains generated by the sale or exchange of employer securities that were taxed at favorable capital-gain rates.<sup>151</sup> Deductions attributable to the repayment of such gains will be treated as capital losses, subject to the limitations applicable to such losses.<sup>152</sup> The

146. See I.R.C. § 102(a) (2006).

147. See I.R.C. § 101(a)(1) (2006).

148. See *Buras v. Comm’r*, 36 T.C.M. (CCH) 1311 (1977); *Shipley v. United States*, 608 F.2d 770, 773 (9th Cir. 1979). Lack of basis is generally used to support the denial of losses, under I.R.C. § 165, whereas the other justifications tend to support the denial of deductions under I.R.C. §§ 162 and 212. The Supreme Court limited, on equitable grounds, a taxpayer’s deduction attributable to refunds of customer overcharges because the overcharges generated a related depletion deduction that was determined as a percentage of gross receipts. *United States v. Skelly Oil Co.*, 394 U.S. 678, 680 (1969). *Skelly Oil* should be limited to situations in which the income item in question triggers a specific deduction and should not apply broadly to cases where the income items generated no additional tax because the taxpayer was in an overall loss position. See, e.g., *O’Meara v. Comm’r*, 8 T.C. 622, 633-35 (1947). For an excellent analysis of *Skelly* see Joel Rabinovitz, *Effects of Prior Year’s Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972).

149. If property is forfeited, then the deductible loss would be limited to the tax basis of the property to the employee at the time of forfeiture. For example, if employer stock is required to be returned to the employer, then the employer’s loss is limited to the basis of the stock and not the fair market value of the stock at the time of forfeiture. Arguably, this limitation arises from the application of I.R.C. § 1001, which provides that gain or loss on the sale or other disposition of property is determined by reference to the amount realized on such sale or disposition and the taxpayer’s basis in the property sold or disposed, and not from the application of judicially developed equitable doctrines. See *infra* notes 235-259 and accompanying text for a discussion of the tax treatment of compensation paid in the form of property.

150. See *infra* note 229 and accompanying text.

151. Such gains are within the scope of § 304 of the Sarbanes-Oxley Act of 2002. See *supra* note 38 and accompanying text.

152. See *infra* notes 153-168 and accompanying text.

seminal case that mandates such a result is *Arrowsmith v. Commissioner*.<sup>153</sup>

At issue in *Arrowsmith* was the characterization of payments made by the former shareholders of a corporation, since liquidated, to satisfy a judgment against the corporation.<sup>154</sup> Several years earlier, the shareholders had received liquidating distributions that were taxed at favorable capital gain rates.<sup>155</sup> Had the corporation satisfied the judgment prior to its liquidation, the shareholders would have received less in liquidation and, therefore, reported a smaller capital gain.<sup>156</sup> The shareholders treated the payments in the later year as an ordinary loss because the payments did not result from a sale or exchange, a requirement for capital gain or loss treatment.<sup>157</sup> The Third Circuit had recently accepted this argument in a similar case.<sup>158</sup> The Second Circuit held, however, that the annual accounting principle did not preclude the examination of the treatment of the transaction in prior years for purposes of characterizing the current year's transaction.<sup>159</sup> Because the payment of the judgment was integrally related to the prior liquidation transaction, the character of the income from the original transaction should govern the character of the later deduction. The Supreme Court affirmed the Second Circuit and noted that the decision did no violence to the annual accounting principle because it did not require the reopening of prior tax years.<sup>160</sup>

The scope of the *Arrowsmith* doctrine has been the subject of debate.<sup>161</sup> The Court in *Skelley Oil*, discussed above, cited to *Arrowsmith* in support of its holding limiting a deduction because the income to which it related was not fully subject to tax.<sup>162</sup> *Arrowsmith*, however, was strictly a characterization issue and did not concern itself with the amount of the item in question—a point noted by Justice Stewart in dissent.<sup>163</sup> Despite the uncertainty about whether *Arrowsmith*

153. 344 U.S. 6 (1952).

154. *Id.* at 7-8.

155. *Id.* at 7.

156. *Id.*

157. Capital gain or loss treatment results from the sale or exchange of a capital asset. *See* I.R.C. § 1222 (2006).

158. *See* *Comm'r v. Switlik*, 184 F.2d 299, 302 (3d Cir. 1950).

159. 193 F.2d 734, 735 (2d Cir. 1951).

160. *Arrowsmith v. Comm'r*, 344 U.S. 6, 8-9 (1952).

161. *See infra* note 163 and accompanying text; Rabinovitz, *supra* note 148, at 87-88.

162. *United States v. Skelley Oil Co.*, 394 U.S. 678, 685 (1969).

163. *Id.* at 697-98 (Stewart, J., dissenting). The taxpayers had paid tax on their previously reported capital gains in full, but at a favorable rate. *Id.* at 698 n.6. Therefore, unlike *Skelley Oil*, the income was subject to tax in full. The Court in *Skelley Oil* did make note of this fact, and admitted

should be extended to cases where the amount of the deduction is in question, its application in characterizing a deduction is not in dispute.<sup>164</sup>

Finally, regardless of the level of employee culpability, the deductibility of compensation repayments pursuant to a clawback agreement should be circumvented neither by the application of I.R.C. section 162(f) nor by resort to some public policy rationale.<sup>165</sup> Section 162(f) disallows a deduction for any fine or similar penalty paid “*to a government* for the violation of any law.”<sup>166</sup> Therefore, amounts paid pursuant to a clawback provision that are remitted to the employer are outside the scope of section 162(f). Moreover, the legislative history of this provision indicates that its passage was intended, in part, to restrain the courts from determining that certain deductions should be denied on public policy grounds.<sup>167</sup>

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that a better analogy would have been drawn had the taxpayers elected, as they were permitted to do under existing law, to exclude fifty percent of the capital gains and forego the favorable capital gain tax rate. *Id.* at 685 n.4. Moreover, the Court went on to state that *Arrowsmith* stood for the proposition that “if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.” *Id.* at 685. In actuality, *Arrowsmith* did not limit the amount of the deduction to account for the lower tax rate applicable to the income to which the deduction related. *See Arrowsmith v. Comm’r*, 344 U.S. 6, 8-9 (1952); *United States v. Skelly Oil Co.*, 394 U.S. 678, 698 n.6 (1969) (Stewart, J., dissenting). Instead, it gave the deduction the same character as the income and thereby subjected it to separate rules limiting capital loss deductions. *See id.* For a critique of an expansive reading of *Arrowsmith*, see Rabinovitz, *supra* note 148, at 87-88.

164. The Second and Ninth Circuits had earlier rendered decisions in cases where a capital-gain transaction generated additional income in subsequent years. Part of the proceeds received in the original transactions had unascertainable values. The subsequent proceeds, if viewed in isolation, would not qualify for capital gains treatment because they did not arise from a sale or exchange in the year they were received. Both courts held that the income received in later years was capital gain based on the character of the original transaction. *See Comm’r v. Carter*, 170 F.2d 911 (2d Cir. 1948); *Westover v. Smith*, 173 F.2d 90 (9th Cir. 1949). Although these cases are often considered “open transaction” cases the courts’ decisions on the character of the income is closely related to the later promulgated *Arrowsmith* doctrine. *See supra* note 106 and accompanying text for a discussion of the open transaction doctrine.

165. I.R.C. § 162(f) (2006).

166. *Id.* (emphasis added).

167. S. REP. NO. 91-552, at 274 (1969). The Supreme Court, prior to the enactment of section 162(f), held that fines paid by a trucking firm to a state for violations of vehicle weight rules were not deductible. *See Tank Truck Rentals, Inc. v. Comm’r*, 356 U.S. 30 (1958). Judicial determinations that the deductibility of certain expenditures would run counter to some public policy were often inconsistent and unpredictable. *See generally* James W. Colliton, *The Tax Treatment of Criminal and Disapproved Payments*, 9 VA. TAX REV. 273, 275-76 (1989). Deductions have been allowed in various settings that would seemingly raise objections on public policy grounds. *See, e.g.*, Rev. Rul. 82-74, 1982-1 C.B. 110 (allowing a deductible loss for restitution payments made by an arsonist); Rev. Rul. 65-254, 1965-2 C.B. 50 (allowing a deduction for the return of embezzled funds). It appears that the Internal Revenue Service and the courts have foregone any resort to broad public policy rationales in denying deductions for payments made in

Repayments of compensation should have little trouble navigating the statutory requirements for deductibility. However, in many cases, if not most, the tax benefit that results from the deduction will not yield the benefit that would have been obtained had the compensation income reported in an earlier year been reduced. In addition to the possibility that the tax rates to which the taxpayer is subject may have changed between the year of income recognition and the year of the reported deduction, the tax code places a number of restrictions on deductions.<sup>168</sup> For example, an individual's deduction for repaid compensation would be classified as a miscellaneous itemized deduction, deductible only to the extent such deductions exceed two percent of adjusted gross income and would be subject to phase-out based on the taxpayer's income level.<sup>169</sup> Moreover, miscellaneous itemized deductions may not provide much, if any, benefit if the taxpayer is subject to the alternative-minimum tax.<sup>170</sup> In fact, a significant level of such deductions may trigger the application of this tax.<sup>171</sup> If, under *Arrowsmith*, the deduction is considered a capital loss, it is deductible only to the extent of capital gains plus \$3,000.<sup>172</sup> Any excess loss is available for

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restitution and instead have allowed I.R.C. § 162(f) to establish the parameters of public policy in this respect. In other settings, equitable doctrines may have vitality. See Craig M. Boise, *Playing with "Monopoly Money": Phony Profits, Fraud, Penalties, and Equity*, 90 MINN. L. REV. 144 (2005). On occasion, deductions related to an activity are categorically denied. See I.R.C. § 280E (2006) (denying any deduction or credit for amounts paid or incurred in carrying on the trade or business of narcotics trafficking).

168. It is possible, of course, that the individual is subject to higher marginal tax rates in the year of repayment, thereby, all things being equal, rendering the deduction more valuable.

169. I.R.C. §§ 67(a); 68 (2006). Trade or business expenses are deductible in arriving at adjusted gross income. However, trade or business expenses incurred by an employee are deductible only from adjusted gross income as itemized deductions. I.R.C. § 62(a)(1) (2006). Certain exceptions are provided for employee business expenses but none are relevant to repaid compensation. See I.R.C. § 62(a)(2) (2006). Miscellaneous itemized deductions are defined as all itemized deductions other than those specifically excepted. Repaid compensation does not fall within one of the enumerated exceptions. See I.R.C. § 67(b) (2006). Section 68 may cause up to 80 percent of miscellaneous itemized deductions to be lost depending on the level of the taxpayer's adjusted gross income. I.R.C. § 68(a) (2006).

170. The alternative-minimum tax is a tax imposed on an expanded tax base. The tax is imposed only if it exceeds the tax liability of the taxpayer determined under regular tax rules and only on the amount of such excess. Generally speaking, this tax is designed to limit the ability of taxpayers to utilize certain statutory tax benefits to minimize their tax liability. See generally I.R.C. §§ 55-59 (2006). Miscellaneous itemized deductions are not deductible in computing the alternative-minimum tax. I.R.C. § 56(b)(1)(A)(i) (2006). A detailed discussion of this tax is beyond the scope of this work. This tax has particular relevance with respect to incentive stock options. See *infra* notes 274-278 and accompanying text.

171. I.R.C. § 1211(b) (2006).

172. *Id.*

carryover to succeeding tax years and is subject to this limitation in each successive year.<sup>173</sup>

#### b. Section 1341

Congress enacted Section 1341 in 1954 in an effort to mitigate the potential inequities that may arise from the strict adherence to the annual accounting principle.<sup>174</sup> Section 1341 provides that the tax benefit resulting from the deduction for the return of previously taxed income will at least equal the reduction in tax that would have resulted had the income reported in a previous year or years been excluded from income.<sup>175</sup> In effect, Section 1341 attempts to place the taxpayer in the same position she would have been in had the return for a previous year or years been amended.<sup>176</sup>

Section 1341 imposes three requirements.<sup>177</sup> First, an item must have been included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such income.<sup>178</sup>

173. 26 U.S.C.A. § 1212(b) (West 2009).

174. See H.R. REP. NO. 83-1337, at 4025-26 (1954).

175. I.R.C. § 1341(a)(4)-(5) (2006). If the tax benefit of the deduction in the year of repayment exceeds the benefit resulting from the exclusion of the income in a prior year or years, the taxpayer is entitled to the benefit of the current deduction. *Id.*

176. If the exclusion of income from a prior year causes a net operating loss, then the decrease in tax resulting from the exclusion is determined by carrying back and forward the loss pursuant to I.R.C. § 172. I.R.C. § 1341(b)(4)(B) (2006). However, the parallel to filing an amended return is not complete. Any refund of tax due as a result of the exclusion of income from a prior year is considered to be a refund of taxes paid in the current year. I.R.C. § 1341(b)(1) (2006).

177. Section 1341 is inapplicable to deductions that relate to income resulting from the sale of inventory with exceptions for certain refunds or rebates made by regulated utilities with respect to rates. I.R.C. § 1341(b)(2) (2006). Likewise, this section is applicable neither to deductions attributable to bad debts nor to deductions attributable to legal fees and other expenses incurred by the taxpayer in contesting the restoration of an item previously included in income. Treas. Reg. § 1.1341-1(g)-(h) (1996).

178. I.R.C. § 1341(a)(1) (2006). A recent case involved the application of I.R.C. § 1341 to deductions that the taxpayer asserted should have been deducted in prior years. Section 1341 is limited to income received under a claim of right. Alcoa incurred waste disposal expenses during the period 1940-1987 and included those costs in its cost of goods sold calculation. *Alcoa, Inc. v. United States*, 509 F.3d 173, 174-75 (3d Cir. 2007). In 1993 Alcoa incurred substantial environmental cleanup costs pursuant to various statutes, including the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. *Id.* at 175. Alcoa, in a novel argument, asserted that the cleanup costs incurred in 1993 should have been part of the cost of goods sold during the 1940-1987 period. *Id.* at 179 n.6. Costs of goods sold are deducted from gross receipts to arrive at gross income. Consequently, Alcoa argued that the failure to take the deductions in earlier years resulted in additional income subject to tax. *Id.* at 179. If the costs were reported in such period, Alcoa would have received greater tax benefits from the deductions than those it would have obtained by deducting such costs in the year incurred, 1993. *Id.* As a result, Alcoa argued it was entitled to the benefits of I.R.C. § 1341. *Alcoa, Inc. v. United States*, 509 F.3d

Second, a deduction must be allowable in the taxable year because it was established, after the close of the prior taxable year, that the taxpayer did not, in fact, have an unrestricted right to all or a portion of the income.<sup>179</sup> Finally, the deduction must exceed \$3,000.<sup>180</sup>

The requirement that the taxpayer have an apparent unrestricted right to the income in the year of receipt precludes the applicability of Section 1341 to deductions arising from the repayment of embezzled funds or from the repayment of income received as a result of arithmetic errors in billing.<sup>181</sup> In neither case does the taxpayer have an apparent right to the income—they have no right to the income at all. The Internal Revenue Service's position is that a taxpayer cannot have an apparent right to income obtained by fraudulent means but judicial guidance on this issue has been somewhat inconsistent.<sup>182</sup> As discussed subsequently, the requirement that a taxpayer have an apparent right to income precludes, in most cases, the application of Section 1341 to the forfeiture of income that was previously taxed as a result of the taxpayer making an I.R.C. § 83(b) election.<sup>183</sup>

At the other end of spectrum, Section 1341 is unavailable for deductions attributable to restorations of income for which the taxpayer had an actual, as opposed to an apparent, right.<sup>184</sup> If the obligation to restore income arises from a subsequent transaction, then the taxpayer's right to income may be deemed absolute at the time of its receipt. For example, a taxpayer was not entitled to the benefits of Section 1341 for a deduction attributable to the refund of prepaid interest that was required

173, 179-80 (3d Cir. 2007). The Third Circuit denied Alcoa's claim and held that, in order for I.R.C. § 1341 to apply, the repayment must arise from the same circumstances, terms, and conditions as the original item. *Id.*

179. I.R.C. § 1341(a)(2) (2006).

180. I.R.C. § 1341(a)(3) (2006).

181. *See, e.g.*, Rev. Rul. 68-153, 1968-1 C.B. 371, 373; *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978); *Yerkie v. Comm'r*, 67 T.C. 388, 392 (1976). *See also* *Perez v. United States*, 553 F. Supp. 558, 561 (M.D. Fla. 1982) (holding that I.R.C. § 1341 was not applicable to repayments of illegal kickbacks).

182. *See* Charlie Boer, *The Right Intention but the Wrong Result: The Misapplication of Section 1341 in Cooper v. United States*, 59 TAX LAW. 1109 (2006) (discussing *Cooper v. United States* in which the court refused to impute taxpayer wrongdoing to a trustee in bankruptcy); Jessica K. Blosser & David W. Freeland, *Pro-Taxpayer Decision on Claim-of-Right Relief*, 36 TAX ADVISER 197 (2005) (describing the Court of Federal Claims allowance of I.R.C. § 1341 for deductions attributable to price fixing settlement payments); William L. Raby, *Taxpayer Repayments and the Tax Benefit Rule*, 97 TAX NOTES 1183 (2002) (noting the Tax Court's refusal to establish a per se disallowance of I.R.C. § 1341 in the case of repayments of illegal income).

183. *See infra* notes 286-289 and accompanying text.

184. *See generally* I.R.C. § 1341.

because the loan to which the interest related was prepaid.<sup>185</sup> The regulatory denial of Section 1341 for bad-debt expenses manifests this position.<sup>186</sup> The Internal Revenue Service has not been consistent in its position with respect to repayment liabilities triggered by subsequent events. On the one hand, it has argued that Section 1341 is inapplicable to repayments of compensation if the obligation to repay the compensation was triggered by a subsequent finding that the compensation expense was not deductible by the employer—a position with which the Sixth Circuit disagrees.<sup>187</sup> On the other hand, the Internal Revenue Service has allowed the use of Section 1341 with respect to commissions repaid as a result of the subsequent failure of customers to pay for the sales on which the commissions were earned.<sup>188</sup>

A host of issues may arise with respect to the applicability of Section 1341 to repayments of compensation pursuant to a contractual clawback provision. Repayments pursuant to retroactive clawback provisions whose reach extend to periods antedating the agreement may not be eligible for Section 1341 treatment—at least with respect to compensation earned prior to the execution of the agreement.<sup>189</sup> A strong case can be made for the fact that, at the time of its receipt, the taxpayer had more than an apparent right to the income. If a clawback is triggered by a restatement of earnings and the taxpayer had a hand in fraudulently reporting the earnings then, arguably, the taxpayer had no right, apparent or otherwise, to the income.<sup>190</sup> Difficult questions are also posed by clawback provisions that are triggered with the benefit of hindsight, but that do not result in restatements. For example, if income must be restored because of subsequent losses or because it is found that the taxpayer took undue risk, then it is unclear whether Section 1341 should apply. It is arguable that, at the time the compensation was received, the taxpayer had more than an apparent right to the income and the triggering of the clawback was precipitated by subsequent events.

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185. Rev. Rul. 58-226, 1958-1 C.B. 318. *See also supra* note 178 (discussing a recent case, *Alcoa, Inc. v. United States*, 509 F.3d 173 (3d Cir. 2007), in which the Third Circuit denied the taxpayer the benefit of I.R.C. § 1341 for environmental remediation costs).

186. *See supra* note 177.

187. *See* Rev. Rul. 69-115, 1969-1 C.B. 50; Rev. Rul. 67-437, 1967-2 C.B. 296; *Van Cleave v. United States*, 718 F. 2d 193, 197 (6th Cir. 1983). *See supra* note 141 for a discussion of repayments due to the Internal Revenue Service's denial of a corporate deduction for compensation payments.

188. Rev. Rul. 72-78, 1972-1 C.B. 45.

189. *See Blanton v. Comm'r*, 46 T.C. 527 (1966).

190. The application of accounting standards often requires the exercise of judgment. Proving that a taxpayer intentionally inflated earnings rather than encountered a bout of undue optimism may be quite difficult.



This position is probably strongest in the case a clawback is triggered by subsequent losses. It is certainly plausible that a clawback triggered by a determination that the taxpayer undertook undue risk rendered the right to the compensation more apparent than real. Presumably, the undue risk was taken in the same year that the compensation was earned despite the fact that the determination of the presence of such risk was made subsequently. The uncertainty surrounding the application of Section 1341 places executives who forfeit compensation that has not been subject to tax in a favorable position when compared to those executives who are forced to disgorge previously taxed compensation.

Section 1341 also requires that a deduction must be allowable to the taxpayer in the taxable year because it was established, after the close of the prior taxable year, that the taxpayer did not, in fact, have an unrestricted right to all or a portion of the income.<sup>191</sup> Section 1341 does not create independent grounds for deducting an expense or loss.<sup>192</sup> However, provided the repayment is involuntary, little difficulty should arise in finding independent grounds for the deductibility of compensation repayments.<sup>193</sup> Moreover, the deductibility of repayments should be unaffected by the wrongdoing, or lack thereof, of the taxpayer in receiving the income in question.<sup>194</sup>

Section 1341 is a fail-safe provision for taxpayers. In the event a current tax deduction yields greater tax benefits in the year of repayment under standard tax rules, the taxpayer is entitled to those benefits and is not limited to the benefits that would have arisen had the income been excluded in the year it was recognized. Whether Section 1341 is beneficial depends on the taxpayer's particular circumstances in both the year of income recognition and the year of repayment. However, repayments of significant amounts of compensation will likely cause the taxpayer to seek refuge in Section 1341. As previously discussed, various limitations on itemized deductions and the application of the alternative-minimum tax may dramatically reduce the value of the tax

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191. See *infra* note 192 and accompanying text.

192. Although the statutory language is relatively clear, the regulations unambiguously lead to this conclusion. Section 1341 will apply only “[i]f, during the taxable year, the taxpayer is entitled under other provisions of Chapter 1 of the Internal Revenue Code to a deduction of more than \$3,000 . . . .” Treas. Reg. § 1.1341-1(a)(1) (1996) (emphasis added). The Supreme Court has similarly interpreted Section 1341. See *United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969) (stating that “the use of the words ‘a deduction’ and the placement of § 1341 in subchapter Q—the subchapter dealing largely with side effects of the annual accounting system—make it clear that it is necessary to refer to other portions of the Code to discover how much of a deduction is allowable”).

193. See *supra* notes 131-142 and accompanying text.

194. See *supra* notes 165-167 and accompanying text.

deduction in relation to the amount of tax imposed on the income in an earlier year.<sup>195</sup> Moreover, in the event the income restored was capital in nature, the *Arrowsmith* doctrine may reduce the benefit of the deduction to insignificance.<sup>196</sup> In the current economic environment, taxpayers with healthy amounts of capital gains are likely to be few and far between.

The extent to which repaid compensation is deductible and the nature of the deduction is dependent upon the original tax treatment of the compensation income which has been clawed back. Likewise, the benefit of Section 1341 is similarly dependent. Section 1341 yields a benefit that mirrors the original tax incurred on the income in question. The taxation of performance-based compensation is highly dependent on the form of such compensation. Significant differences in the timing of income recognition and the character of the income will result in concomitant differences in the deductions available upon repayment.

### *C. Taxation of Performance-Based Compensation*

The tax consequences of performance-based compensation that has been subject to clawback will depend, to a great extent, on the tax consequences to the employee upon the receipt of the compensation. Performance-based compensation is payable either in cash or property. Compensation payable in cash generally takes the form of a cash bonus or stock appreciation rights. Bonus payments are usually, but not always, determined on the basis of pre-defined metrics that vary depending on the nature of the employer's business and the incentives which such employer seeks to put in place. Commonly employed metrics include firm- or unit-wide measures such as return on equity, net earnings, market share, sales growth, and the like. Metrics that focus on individual or group performance are also prevalent.<sup>197</sup> Stock-appreciation rights determine compensation based on the growth of the firm's stock price between the date such rights are granted and the date such rights are exercised.<sup>198</sup> Property-based compensation arrangements typically grant employees employer stock or options to purchase

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195. See *supra* notes 168-173 and accompanying text.

196. See *supra* notes 151-164 and accompanying text.

197. Performance-based compensation is not subject to the \$1 million limit on the deductibility of certain executive compensation. See *infra* note 250 and accompanying text.

198. Stock appreciation rights may also credit the employee with dividends that are paid on the stock.

employer stock.<sup>199</sup> The tax issues incident to cash compensation arrangements are generally limited to the timing of the employee's income inclusion. The receipt of employer stock or options on such stock raise additional issues.

### 1. Cash Compensation

Performance-based compensation payable in cash is taxable to the recipient in the year such compensation is actually or constructively received.<sup>200</sup> Income is constructively received by a taxpayer if such income is credited to her account, set apart for her, or otherwise made available to be drawn upon without substantial limitations or restrictions.<sup>201</sup> It is not uncommon for employers to defer all or a portion of the incentive compensation or, alternatively, to offer the recipients the option to defer all or a portion of such compensation. The specifics of the deferral arrangements vary from firm to firm, but generally deferral arrangements provide specific timeframes under

199. The term "employer stock" includes stock of the parent corporation in cases where the employees are employed by a controlled subsidiary of the parent.

200. Treas. Reg. § 1.451-1(a) (1999). It is assumed that the employee utilizes the cash-basis of method of accounting. *Id.* The cash basis method of accounting is used by virtually all individuals. Self-employed individuals may elect, or be required to, utilize the accrual method of accounting for their business operations. *See* Treas. Reg. § 1.446-1(c)(2)(i) (2006) (mandating accrual accounting for purchases and sales if the taxpayer maintains an inventory). Individuals may also recognize income on the accrual basis by virtue of reporting their share of partnership income if such partnership utilizes the accrual method of accounting. *See generally* I.R.C. §§ 702; 703(b) (2006). Under the accrual method of accounting, income is recognized at the time all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a) (1999). The employer, in most instances, will be an accrual-basis taxpayer. Therefore, the employer's compensation deduction may be accrued at the time various statutory tests are met. In general, expenses are accruable at the time economic performance has taken place. Generally, economic performance will occur at the time the services to which the liability relates have been rendered. *See* I.R.C. § 461(h)(2)(A)(i) (2006); Treas. Reg. § 1.461-4(d)(6) (1999). However, accruals for compensation expense are generally limited to amounts that are paid within two and one-half months after the end of the corporation's taxable year. *See* Temp. Treas. Reg. 1.404(b)-1T, A-2(b)(1) (1992).

201. Treas. Reg. § 1.451-2 (1979). Generally, a taxpayer will be deemed to be in constructive receipt of income if the funds are set aside and not subject to the general claims of the employer's creditors or if the agreement to defer income is executed after the services that give rise to the claim for compensation are rendered. *See, e.g.*, Rev. Rul. 70-435, 1970-2 C.B. 100; Rev. Rul. 64-279, 1964-2 C.B. 121; Rev. Rul. 60-31, 1960-1 C. B. 174. Section 409A, discussed at *infra* notes 203-219 and accompanying text, imposes additional requirements on the ability to defer compensation. The doctrine of constructive receipt should not be confused with the constructive realization of income. In certain cases, statutory rules require that income be realized prior to the time that such income would have been realized under general income realization principles. For example, mark-to-market accounting rules will result in income realization despite the absence of a transaction that results in a disposition of the asset in question. *See, e.g.*, I.R.C. §§ 475; 1256 (2006).

which the deferred amounts may be withdrawn, may provide for interest accruals on the amounts deferred, and may provide offsets for amounts payable under qualified plans. Amounts deferred may also be subject to substantial risk of forfeiture due to, for example, a continuing employment requirement. Whether, and to what extent, bonus-deferral arrangements succeed in postponing the employee's incidence of taxation depends on whether the deferral arrangements meet the requirements of Internal Revenue Code Section 409A. Prior to the enactment of Section 409A, the only obstacle to the postponement of income recognition that such arrangements faced was the doctrine of constructive receipt—an obstacle easily avoided.<sup>202</sup>

The American Jobs Creation Act of 2004<sup>203</sup> added Section 409A to the Internal Revenue Code to combat perceived abuses in the design and operation of deferred-compensation plans.<sup>204</sup> Particular opprobrium was directed at deferred-compensation plans or arrangements that granted employees a great deal of control or access to amounts deferred and those plans or arrangements designed to effectively shield assets of the employer from the claims of creditors.<sup>205</sup> Section 409A imposes certain operational and design requirements on deferred compensation plans within its scope.<sup>206</sup> The statute has a broad reach, encompassing any plan, other than those specifically exempted, that provides for the

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202. Unfunded deferred compensation arrangements, if properly implemented, generally raise no constructive-receipt issues because the employee has received nothing more than the employer's unsecured promise to pay the compensation at some future point in time. Funded deferred-compensation plans will also not result in constructive receipt provided, among other requirements, that the assets held by the employer to secure the obligation to pay the deferred compensation are subject to the claims of the employer's creditors. The Internal Revenue Service has issued guidance and a model trust agreements for these funded arrangements, known as "Rabbi Trusts." *See* Rev. Proc. 92-64, 1992-2 C.B. 422.

203. Pub. L. No. 108-357, §885(a), 118 Stat. 1418, 1634-41 (2004).

204. This provision does not override other statutory provisions or any other rule of law that would require income to be recognized earlier than the time required by § 409A. *See* I.R.C. § 409A(c) (2006). The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 801, 122 Stat. 3765, 3929-30 (2008), added § 457A to the Internal Revenue Code. This provision requires recognition of income from nonqualified deferred compensation plans maintained by certain tax-indifferent corporations and partnerships at the time the income is no longer subject to a substantial risk of forfeiture. In general, deferred-compensation plans of foreign corporations and partnerships that allocate more than an insubstantial portion of their income to foreign corporations and tax-exempt entities are subject to § 457A. Exceptions are made for foreign corporations that are subject to a comprehensive foreign income tax or that earn substantially all of their income in connection with the conduct of a trade or business in the United States. *See generally* Notice 2009-8, 2009-4 I.R.B. 347, § 6, Question 6 (Jan. 26, 2009).

205. H.R. REP. NO. 108-548, pt.1, at 343 (2004).

206. *See infra* note 208 and accompanying text.

deferral of compensation.<sup>207</sup> Effective for amounts deferred after December 31, 2004, Section 409A(a)(1) requires that all compensation deferred under the plan for the taxable year and all preceding taxable years be included in gross income during the taxable year in which the deferred compensation plan fails to meet the requirements specified in the statute.<sup>208</sup> Moreover, interest is imposed on the amount of compensation included in gross income pursuant to this provision in addition to a twenty percent penalty on the amount so included.<sup>209</sup>

Regulations implementing the statute provide that a deferral of compensation exists if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right to compensation during the taxable year and such compensation is payable, pursuant to the terms of the plan, in a later year.<sup>210</sup>

In the event the service recipient or other person may eliminate or unilaterally reduce the compensation due to the service provider, then no

207. Qualified employer plans, such as pension and profit sharing plans, as well as bona fide vacation, sick leave, compensatory time, disability pay, and death benefit plans are not subject to these provisions. See I.R.C. § 409A(d)(1)-(2) (2006). The I.R.S. has broad regulatory authority to exempt arrangements from the application of § 409A if such arrangements will not result in improper deferral of U.S. tax and do not place assets beyond the reach of creditors. I.R.C. § 409A(e)(3) (2006). Recently issued regulations exempt various medical reimbursement arrangements and medical savings accounts from the application of § 409A. See generally Treas. Reg. § 1.409A-1(a)(5) (2007). The regulations also exclude from § 409A deferral arrangements that arise due to customary payroll procedures. For example, compensation is not deemed deferred solely because the service provider is paid after the last day of such provider's taxable year if such payment is made under normal payroll timing procedures. Treas. Reg. § 1.409A-1(b)(3) (2007). Also not subject to § 409A are short-term deferrals. Absent an election to defer by the service provider, compensation actually or constructively received by the later of the fifteenth day of the third month following the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or the fifteenth day of the third month following the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture is not subject to section 409A. Treas. Reg. § 1.409A-1(b)(4)(i) (2007).

208. Deferred compensation includes earnings, whether actual or notional, attributable to deferred compensation or income. I.R.C. § 409A(d)(5) (2006). A plan failure will not result in the application of this provision to all participants, only to those individuals to whom the plan failure relates. I.R.C. § 409A(a)(1)(A)(ii) (2006). Proposed regulations were recently issued that provide guidance on the calculation of required income inclusions and penalties for noncompliant plans. See generally Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380 (Dec. 8, 2008). Note that the Internal Revenue Service will not issue rulings on whether a particular nonqualified deferred compensation plan is subject to § 409A. See Rev. Proc. 2009-3, 2009-1 I.R.B. 107 (Jan. 5, 2009).

209. I.R.C. § 409A(a)(1)(B)(i) (2006). Interest is determined by applying the underpayment rate plus one percentage point to underpayments that would have resulted had the deferred-compensation amounts been included in the tax year deferred or, if later, in the taxable year such deferred compensation was no longer subject to a substantial risk of forfeiture. I.R.C. § 409A(a)(1)(B)(ii) (2006).

210. Treas. Reg. § 1.409A-1(b)(1) (2007).

legally binding right to the compensation exists.<sup>211</sup> However, if the unilateral right to reduce or eliminate the compensation is exercisable only upon a condition, or if such discretion lacks substantive significance, then such right is ignored.<sup>212</sup> The regulations state: “[C]ompensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as application of a *nondiscretionary, objective* provision creating a substantial risk of forfeiture.”<sup>213</sup>

Deferred-compensation plans subject to an objective, nondiscretionary clawback feature, such as those triggered by earnings restatements, will, therefore, be subject to Section 409A, despite the fact that all or a portion of the compensation may be forfeited. It is not clear, however, whether clawbacks triggered by the application of vague, generalized standards, such as those applicable to the undertaking of excessive or undue risk, will be considered sufficiently nondiscretionary and objective for this purpose. It is hard to imagine that an employer’s discretion in asserting clawback rights in such situations would be unfettered. At a minimum, there would appear to be duty of good faith and, perhaps, a reasonable-person standard in assessing whether the employee took on excessive or undue risk. Many clawback provisions are applicable at the discretion of the board of directors and, depending on the specific terms of such provisions and the extent of the board’s discretion, it is possible that Section 409A may not apply to deferred compensation subject to such clawback provisions—at least while the compensation is subject to clawback.<sup>214</sup>

A detailed analysis of Section 409A is beyond the scope of this work. In general terms, three design and operational requirements are imposed on covered nonqualified deferred compensation arrangements.<sup>215</sup> First, the plan may not permit early distributions, as defined.<sup>216</sup> Second, the plan may not permit the acceleration of benefits

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211. *Id.*

212. *Id.*

213. *Id.* (emphasis added).

214. *See supra* notes 77-81 and accompanying text.

215. *See infra* notes 216-218 and accompanying text.

216. A plan may not permit deferred compensation to be distributed earlier than separation from service, disability, death, a specified time pursuant to a fixed schedule specified in the plan, change in control events, or the occurrence of an unforeseeable emergency. I.R.C. § 409A(a)(2)(A)(i)-(vi) (2006).

except as otherwise permitted.<sup>217</sup> Finally, deferral elections, and certain changes thereto, must be made within prescribed time frames.<sup>218</sup> Nonqualified deferred compensation plans subject to Section 409A may provide participants with deferral elections only if the election to defer is made by the end of the preceding taxable year or such other time provided in regulations.<sup>219</sup>

In the event that a taxpayer is required, pursuant to a clawback provision, to return cash compensation to the employer, the tax consequences of the repayment will depend on several factors. The most straightforward scenario would involve the repayment of a cash bonus earned in prior years but subject to repayment through no fault of the employee. For example, the repayment obligation may be triggered by a restatement of earnings upon which the bonus was calculated, and the restatement was not caused by any action of the employee obligated to repay the compensation. A repayment under these circumstances would be deductible and, moreover, should be eligible to the benefits offered by Section 1341. At the time the bonus was received, the employee had an apparent, but not absolute right, to the income.<sup>220</sup> The fact that the

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217. Pursuant to the terms of the plan, an initial deferral election, or subsequent deferral election, payments may be accelerated due to separation from service, death, disability, change on control, or unforeseeable emergencies. *See* Treas. Reg. § 1.409A-3(j) (2007). Payments may be made to a person other than the service provider pursuant to a domestic relations order. Treas. Reg. § 1.409A-3(j)(4)(ii) (2007). Payments may also be made to comply with an order of divestiture due to conflicts of interest pursuant to I.R.C. § 1043 or, for arrangements subject to I.R.C. § 457(f), to pay taxes upon a vesting event. Treas. Reg. § 1.409A-3(j)(4)(iii)-(iv) (2007). Moreover, payments may be made to pay certain employment taxes or to the extent of amounts included in gross income as a result of a plan failing to meet the requirements of § 409A. Treas. Reg. § 1.409A-3(j)(4)(vi)-(vii) (2007). The rules also provide service recipients with a modicum of flexibility by allowing such service recipients to unilaterally pay amounts due to separated participants in lump sum form. Treas. Reg. § 1.409A-3(j)(4)(v) (2007).

218. Participants in their first year of eligibility under the plan may elect to defer within thirty days of their eligibility date. I.R.C. § 409A(a)(4)(B)(i) (2006). In the case of performance-based compensation covering a period of at least twelve months, a participant may elect to defer compensation no later than six months before the end of the service period. I.R.C. § 409A(a)(4)(B)(iii) (2006). Service providers who are awarded bonuses or other compensation in the middle of a year will find the general rule applicable to timing of deferral elections useless. For example, an election to defer compensation under a bonus program instituted in 2008 that covers services provided in 2008 would have to be made by the service provider by December 31, 2007. Unless the service provider is unusually prescient, it is unlikely that such an election will have been made. The regulations, however, provide that an election to defer compensation subject to a substantial risk of forfeiture due to a condition requiring at least twelve months of continued service by the service provider may be made within thirty days after the service provider obtains a legally binding right to payment and within at least twelve months prior to the earliest date that the forfeiture condition could lapse. Treas. Reg. § 1.409A-2(a)(5) (2007).

219. I.R.C. § 409A(a)(4)(B)(i) (2006).

220. *See supra* note 178 and accompanying text.

employee had no right to the income was established after the close of the taxable year in which the income was received.<sup>221</sup> Assuming the amount of compensation repaid exceeds \$3,000, Section 1341 should apply.<sup>222</sup>

The application of Section 1341 is less clear in the event that the taxpayer bore some level of culpability for the earnings restatement or if the clawback is triggered by subsequent events. In the event that the employee, through deliberate action, knowingly falsified earnings or other relevant metrics in order to increase the bonus payable, then a strong case may be made that Section 1341 should be inapplicable. In such a case, the employee had no right to the income, apparent or otherwise.<sup>223</sup> Generally, only high-level employees have the wherewithal to doctor earnings. However, in certain cases, lower-level employees may have significant sway over the metrics upon which a bonus is determined.<sup>224</sup> For example, a bonus based on gross revenues, growth in gross revenues, or gross revenues in excess of a pre-defined threshold may tempt employees to inflate sales through improper techniques—channel stuffing, for example.<sup>225</sup> Section 1341 should be denied in such cases. The more localized the metrics, the greater the control that can be exercised by lower-level employees.<sup>226</sup>

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221. See *supra* note 179 and accompanying text.

222. See *supra* note 180 and accompanying text.

223. See *supra* notes 181-182 and accompanying text.

224. See *infra* note 225 and accompanying text.

225. Channel stuffing refers to the practice of placing larger quantities of inventory than needed by a customer, coupled with a side agreement that the excess inventory will be returned. Other techniques for inflating revenue include mischaracterization of contract terms and bifurcation of contracts to allow sellers with on-going service obligations to recognize greater revenue from transactions than would otherwise be appropriate. The software industry is particularly vulnerable to such practices. See generally RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5, § 83(b) (Fin. Accounting Standards Bd. 1984); SOFTWARE REVENUE RECOGNITION, STATEMENT OF POSITION 97-2 (Am. Inst. of Certified Pub. Accountants 1977); *Revenue Recognition in Financial Statements*, SEC STAFF ACCOUNTING BULLETIN NO. 101 (Dec. 3, 1999), available at <http://www.sec.gov/interps/account/sab101.htm>. “Round-tripping” is another form of revenue manipulation. A “round-trip” transaction is one in which the purchaser receives funds from the seller and undertakes a reciprocal obligation to purchase goods or services from the seller. See, e.g., David D. Kirkpatrick, *Shares Are Up, But Lawsuits May Unsettle AOL's Future*, N.Y. TIMES, July 7, 2003, at C1 (reporting on litigation commenced against AOL for purportedly inflating revenue by \$190 million through “round-trip” transactions). See also Daniel V. Dooley, *Financial Fraud: Accounting Theory and Practice*, 8 FORDHAM J. CORP. & FIN. L. 53 (2002).

226. Metrics that are based on the performance of a single unit or division may be influenced by employees in the unit or division. At the extreme, metrics based on individual performance measurements are susceptible to influence by the individual employee to whom the metric relates.



A more contentious issue will arise if the clawback is triggered by subsequent events. For many reasons, earnings that are properly reported in an earlier period may ultimately prove ephemeral with the benefit of hindsight. However, the prior year earnings may not be subject to restatement. Instead, losses are recognized in a later period. The current predicament in which many financial institutions find themselves has been caused, in large part, by seemingly profitable transactions ultimately proving unprofitable as a result of subsequent events. Clawbacks triggered under such circumstances may not be eligible for Section 1341 treatment. The Internal Revenue Service is likely to argue that, at the time that the compensation was earned, the taxpayer had an absolute, not apparent, right to the income.<sup>227</sup> If an employer finds it necessary to institute a clawback to recoup income in such circumstances then it may behoove the employer to defer the bonus until it can be determined, with the benefit of hindsight, whether it has, in fact, been earned. Not paying the bonus in the first place is much cleaner than paying it and subsequently requesting the employee to pay it back.<sup>228</sup>

If the clawback provision causes the forfeiture of deferred cash compensation then, unless the requirements of section 409A have not been met throughout the deferral period, the clawback provision will have no tax consequences.<sup>229</sup> Because the income has never been realized by the employee, its subsequent forfeiture is a non-event—tax wise, at least. If, however, Section 409A served to accelerate the taxation of the deferred compensation then the tax consequences of the forfeiture of the deferred compensation would be similar to those discussed above with respect to cash bonuses.<sup>230</sup> As mentioned previously, Section 409A also imposes, in addition to the regular tax on the deferred earnings, an interest charge and twenty percent penalty.<sup>231</sup> If Section 1341 applies, the statutory language allows for the recoupment of the interest and penalty. The benefit derived under Section 1341 is determined by the “the decrease in tax under *this chapter*” that would have resulted if the income had not been reported in

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227. See *supra* notes 185-187 and accompanying text.

228. This is a common practice with respect to sales commissions. Many employers remit commissions only after the sale on which the commissions were earned have been paid for by the customer.

229. This assumes, of course, that the employee was not in constructive receipt of the deferred income. See *supra* note 201 and accompanying text.

230. See *supra* note 207 and accompanying text.

231. See *supra* note 209 and accompanying text.

the year of receipt.<sup>232</sup> Section 409A states that “the tax imposed by *this chapter*” is increased by the interest and penalty.<sup>233</sup> Therefore, the interest and penalty charges imposed under Section 409A are deemed taxes under Chapter 1 and, therefore, may be recouped by the application of Section 1341.<sup>234</sup>

## 2. Compensation Paid in Property.

It is also common for performance-based compensation to be paid in property—typically employer stock or options on employer stock. Stock-based compensation systems are justified, in part, by the propensity of such arrangements to align the interests of management and shareholders—a justification that has, in recent years, been called into question.<sup>235</sup> Section 409A is less of a concern with respect to equity based compensation because the regulations provide a broad exemption for certain equity based compensation arrangements. For example, Treas. Reg. Section 1.409A-1(b)(5)(i)(A) exempts, from the application of section 409A, options to purchase service recipient stock subject to taxation under Section 83 provided that the number of shares subject to the option is fixed at the date of grant, the exercise price of the stock is not less than the fair market value of the stock on such date, and that no deferral feature, other than the deferral of income until exercise, is provided.<sup>236</sup> In effect, provided that the option, at the date of grant, is not in the money and no deferral feature is provided, it will be exempt from Section 409A.<sup>237</sup>

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232. I.R.C. § 1341(a)(5)(B) (2006) (emphasis added).

233. I.R.C. § 409A(a)(1)(B) (2006) (emphasis added).

234. This is not the case with respect to the 20 percent excise tax imposed on excess golden-parachute payments pursuant to I.R.C. § 4999. This tax is imposed under Chapter 46 and, therefore, is outside the scope of I.R.C. § 1341. Consequently, the recipient of excess parachute payments subject to this tax would be unable to recoup this tax through the utilization of I.R.C. § 1341. See I.R.C. § 4999(b) (2006) and 280G(b) (2006) for the definition of excess parachute payments. Golden-parachute payments have been restricted for recipients of federal bailout funds. See *supra* notes 45 and 55 and accompanying text.

235. See, e.g., Bebhuk et. al., *supra* note 26. Stock-based compensation schemes are also utilized to avoid the limitation on the deductibility of executive compensation and, in the case of stock options, offered financial accounting benefits. See *infra* notes 248 and 251 and accompanying text.

236. The payment of the exercise price with previously acquired shares does not jeopardize the exemption. See Treas. Reg. § 1.409A-1(b)(5)(i)(D) (2007).

237. Moreover, grants of incentive stock options or options granted under an employee stock purchase plan pursuant to I.R.C. § 423 are categorically exempted from § 409A. Treas. Reg. §§ 1.409A-1(b)(5)(i)(C); 1.409A-1(b)(5)(ii) (2007). For a discussion of the taxation of incentive stock options see *infra* notes 251-69 and accompanying text. Similar rules are applicable to stock appreciation rights. Treas. Reg. § 1.409A-1(b)(5)(i)(B) (2007). The receipt of stock subject to a

Internal Revenue Code Section 83(a) provides the general rule that the actual or constructive receipt of property in exchange for services is a taxable event at the time the property so received is transferable by the recipient or not subject to a substantial risk of forfeiture, whichever occurs earlier.<sup>238</sup> The amount of income recognized from such a transaction is the excess of the fair market value of the property received over the amount paid by the recipient for such property.<sup>239</sup> Correspondingly, the transferor of the property is entitled to a compensation deduction, at the time the recipient of the property recognizes income, equal to the amount includible in the income of the recipient.<sup>240</sup> Consequently, receipt of employer stock that is immediately vested with the employee results in income, at the time of receipt, equal to the fair market value of the stock received.<sup>241</sup>

If, however, the stock is subject to a substantial risk of forfeiture, then income recognition is postponed until such time as the risk of forfeiture lapses. A substantial risk of forfeiture may be present as a result of performance targets that must be met or by the presence of a continuing employment requirement. For executives whose compensation is subject to the \$1 million deduction, limitations on performance-based restrictions are typical.<sup>242</sup> For other employees, a continuing employment restriction may be the extent of the forfeiture risk. For example, assume an employee received a

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substantial risk of forfeiture is generally not considered to result in a deferral of compensation for purposes of § 409A. See Treas. Reg. § 1.409A-1(b)(6) (2007).

238. I.R.C. § 83(a)(1) (2006).

239. I.R.C. § 83(a)(1)-(2) (2006). The fair market value of the property received is determined at the time the property is transferable by the recipient or is not subject to substantial risk of forfeiture, whichever is earlier. I.R.C. § 83(a)(1) (2006). Senator Carl Levin introduced legislation in 2007 that, for nonqualified stock options, would decouple the amount of the employer's deduction from the amount of the employee's income inclusion. The employer's deduction would be determined by the amount of compensation expense recognized for financial accounting purposes. Moreover, the bill would eliminate the exemption of nonqualified stock options from the \$1 million expense limitation imposed by I.R.C. § 162(m). See Ending Corporate Tax Favors for Stock Options Act, S. 2116, 110th Cong. (2007).

240. I.R.C. § 83(h) (2006). If appreciated or depreciated property is transferred to compensate for services received then the transferor will recognize a gain or loss on the transfer as if the property were sold for its fair market value. Because a corporation recognizes no gain or loss on the transfer of its stock, or options thereon, this issue does not present itself in this context. See I.R.C. § 1032(a) (2006).

241. Any amount paid by the employee for the shares would, of course, reduce the amount of compensation.

242. See *infra* note 250 for a discussion of the \$1 million deduction limitation and the exception to such limitation for performance-based compensation. A grant of stock that is awarded without regard to some performance-based measurement will not qualify for the exception. See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1995). Stock options, on the other hand, are deemed performance-based provided that they are not in-the-money when granted. See *infra* note 250 and accompanying text.

grant of 10,000 shares of stock but the stock was subject to a four-year vesting schedule pursuant to which 25 percent of the stock vested on each of the first four anniversary dates of the grant. The employee must be employed with the firm on the vesting dates. Assuming that the employee remained with the firm throughout the vesting period, such employee would recognize income in each of the succeeding four years equal to the fair market value, determined at the time of vesting, of 2500 shares of employer stock. It is likely that the trend toward “hold til (or through) retirement” policies, with respect to performance-based awards, will result in a significantly greater number of employees that are subject to vesting schedules for a portion of their compensation.<sup>243</sup>

The postponement of taxation until the lapse of the vesting restrictions imposed under the plan could expose the employee to a significant tax liability if the stock’s value increases significantly between the time of grant and the time that the stock is no longer subject to substantial risk of forfeiture. As a consequence, the benefits of capital gains tax rates and much, if not all, of the benefits of deferral may be lost with respect to the increase in value that occurs between the time of the stock’s grant and the date that the stock is no longer restricted. Moreover, in order to pay the tax, the employee may be forced to sell the stock which diminishes the incentive alignment that was a principle reason for the stock’s issuance.<sup>244</sup> The governing statute, however, provides the property recipients with an alternative to the general rule.<sup>245</sup>

Internal Revenue Code Section 83(b) offers the property recipient an election to accelerate the incidence of taxation to the time that the property is transferred.<sup>246</sup> Subsequent appreciation would be taxable if, and when, the taxpayer disposes of the stock and would be taxed at capital-gain rates. This election also accelerates the employer’s compensation deduction. The election is not risk free, however. In a declining market, the option holder will have recognized an amount of

243. See *supra* note 76 and accompanying text.

244. After the passage of the Sarbanes-Oxley Act of 2002, employers could no longer make loans to any director or executive officer. Sarbanes-Oxley Act of 2002, Pub L. No. 107-204, § 402(a), 116 Stat. 745, 787 (2002) (codified as amended at 15 U.S.C. § 78m(k)(1) (2006)). This provision removes a significant source of liquidity for many executives. *Id.*

245. See I.R.C. § 83(b) (2006).

246. I.R.C. § 83(b) (2006). Section 83 applies to any property transferred in connection with the performance of services even in cases where the service provider has paid fair market value for the property. See *Alves v. Comm’r*, 734 F.2d 478, 479 (9th Cir. 1984). Therefore, despite the fact that an employee has purchased restricted stock at the market price, in the absence of an I.R.C. § 83(b) election, appreciation up to the point the restrictions lapse will cause the stockholder to recognize compensation income.

compensation income based on the value of the stock at the date of grant. Any subsequent decline in the value of the stock will generate a capital loss upon disposition of the stock.<sup>247</sup> Moreover, if the employee fails to meet the vesting requirements, no loss is recognized upon the forfeiture of the shares.<sup>248</sup>

Nonqualified stock options are also a commonly used method of payment in performance-based compensation schemes.<sup>249</sup> These instruments offer several benefits to both the recipient and grantor of the options. For the grantor, these instruments allow compensation to avoid the limitation placed on deductions for executive compensation.<sup>250</sup> Moreover, until recently, payment of compensation in the form of stock options enjoyed favorable treatment for financial accounting purposes.<sup>251</sup>

247. Note that the election is irrevocable, except with the permission of the Commissioner. I.R.C. § 83(b)(2) (2006); Treas. Reg. § 1.83-2(f) (1978).

248. I.R.C. § 83(b) (2006).

249. Incentive stock options are not subject to the general tax rules set forth in I.R.C. § 83. These instruments are subject to different, very taxpayer-friendly rules and comprise a very limited part of executive compensation packages. *See infra* notes 260-69 and accompanying text.

250. I.R.C. § 162(m)(1)-(3) (2006) provides that publicly traded corporations may not deduct compensation in excess of \$1 million paid to the chief executive officer or the four highest paid officers other than the chief executive. However, this limitation does not apply to performance-based compensation. Performance-based compensation is defined as any remuneration payable solely on account of the attainment of one or more performance goals I.R.C. § 162(m)(4)(C) (2006). Such performance goals must be determined *ex ante*, and certified *ex post*, by an independent compensation committee of the board of directors and approved by the shareholders. I.R.C. § 162(m)(4)(C)(i)-(iii) (2006). The regulations interpreting this provision provide that compensation attributable to stock options is deemed to be performance-based if, *inter alia*, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of grant or award. Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1995). Therefore, at-the-money or out-of-the-money options are considered performance-based while in-the-money options are not, and no distinction is made between stock appreciation caused by market forces and firm-specific appreciation. In effect, any appreciation in the stock is considered performance-based. The regulations provide certain limitations on option cancellations and re-pricings. If options are cancelled and reissued due to a decline in the stock price, then the cancelled options are counted toward the maximum number of shares, with respect to which the options may be granted under the plan. Treas. Reg. § 1.162-27(e)(2)(vi)(B) (1995). Likewise, if options are re-priced, the regulations deem the original options to have been cancelled and new options issued. *Id.* The regulations provide exceptions for re-pricings that are prompted by certain corporate recapitalizations. *See* Treas. Reg. § 1.162-27(e)(3)(iii)(C) (1995); I.R.S. Priv. Ltr. Rul. 2000-51-018 (Sept. 18, 2000). Senator Carl Levin has introduced legislation that would subject nonqualified stock option compensation to the \$1 million compensation limit. *See supra* note 239. Recent legislation and Treasury regulations have reduced the \$1 million limitation to \$500,000 in the case of financial institutions participating in certain federal programs. *See supra* note 47 and accompanying text.

251. In 1993 the Financial Accounting Standards Board issued an exposure draft that would have required that the issuance of compensatory stock options be accounted for as an expense in an amount determined under fair market value models. The business community in general and the technology industry in particular fought the proposal vehemently. The Financial Accounting Standards Board, under pressure from Congress, relented. *See generally* Melone, *supra* note 2, at

The option recipient obtains the benefits of tax deferral. Nonqualified stock options are subject to taxation in accordance with tax principles applicable to compensatory transfers of property in general.<sup>252</sup> However, Treasury regulations provide that, with respect to the receipt of compensatory stock options, the incidence of taxation is postponed until such time that the options are exercised or are otherwise disposed of—if, at the time the options are granted, they have no readily ascertainable fair market value.<sup>253</sup> Compensatory stock options are rarely subject to tax when granted.<sup>254</sup>

Due to the symmetry that Section 83 creates between the timing and amount of the employee's income inclusion and the employer's deduction, the benefit of the employee's income deferral is offset by the concomitant deferral of the employer's deduction. From the employee's perspective, the advantage of tax deferral is equivalent to an exemption from tax on investment earnings on the after-tax compensation amount that would have been received had compensation not been deferred.<sup>255</sup> Stock options exaggerate this benefit due to the leverage inherent in such

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554-58. In the aftermath of the corporate scandals that came to light earlier this decade public sentiment turned markedly negative about the levels of executive compensation and efforts to require expensing such options gained traction. The Financial Accounting Standards Board issued a new standard that requires expensing of options effective, for most public companies, for interim and annual reporting periods beginning after June 15, 2005. See SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards, No. 123 (Fin. Accounting Standards Bd. 2004). Recently introduced legislation would conform the employer's tax treatment of such options to their treatment for financial accounting purposes. See *supra* note 239.

252. The extent of the relative deferral and conversion benefits enjoyed by recipients of compensatory stock options vary depending on whether the options are qualified or nonqualified. Qualified stock options are of two types: incentive stock options and those granted pursuant to an employee stock purchase plan. The recipient of an incentive stock option does not recognize taxable income upon either the grant of the option or its exercise. Rather, the incidence of taxation is postponed until the option holder disposes of the stock acquired through the exercise of the option, at which time the income is taxed at capital-gain rates. See *infra* notes 260-278 and accompanying text.

253. Treas. Reg. § 1.83-7(a) (2004). The regulations make clear that the incidence of taxation is postponed until the date of exercise even though the option's value is readily ascertainable prior to exercise but after the date of grant. *Id.*

254. An option has an ascertainable fair market value if it is either actively traded on an established market or is transferable by the option holder, is immediately exercisable, and if the underlying property that is the subject of the option is subject to no restriction that has a significant effect on such property's value. Treas. Reg. § 1.83-7(b) (2004). Section 83(b) elections, discussed at *supra* notes 246-248 and accompanying text, can have relevance to recipients of stock options. Such an election may be advantageous if the stock received upon exercise of the options is subject to a substantial risk of forfeiture at the time of exercise.

255. See David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 709-10 (2005).

instruments.<sup>256</sup> The tax benefits available to the employee may be captured by the employer or the government, or both.<sup>257</sup> The deferral benefits that attach to compensatory stock options are directly attributable to the fact that such options' value is not ascertainable at the

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256. Tax deferral mimics the exemption of income on after-tax earnings. Therefore, the benefits of tax deferral increase as the rate of return on investment increases. For example, if an employee receives \$1,000 in cash compensation she will retain, assuming a 30 percent tax rate, \$700. Assume that the \$700 were invested in employer stock and held for five years at which point the stock has doubled in value. Assuming a 15% capital gains tax the employee will be left with \$1295 (gross proceeds of \$1400 less capital gains tax of \$105). Alternatively, if the employee deferred the compensation for five years at which time the amount deferred doubled in value then the employee would incur a tax of \$600 (30 percent of \$2,000), leaving the employee with \$1,400. The difference between the two amounts is the amount of the tax incurred on the gain that resulted from the investment purchased with after-tax dollars, or \$105. Deferred compensation is disadvantageous during a period of falling asset values. See Walker, *supra* note 255, at 715-17 (noting that the disadvantages are mitigated by the limitations imposed on the use of capital losses and the possibility that the terms of the stock option grant may be adjusted ex-post).

257. A deferred-compensation arrangement frees up employer cash that otherwise would have been used to compensate employees. If the employer invests the cash in operations, any increase in operating earnings would increase taxable income and the tax on such increase would offset some of the tax savings enjoyed by the employee. Alternatively, the employer may use such cash to purchase its own shares or options on such shares in which case the return on the invested cash is tax-free causing the U.S. Treasury to bear the burden of the tax savings. See I.R.C. § 1032 (2006). Corporations with significant net operating losses will also avoid tax on investment earnings, regardless of the source of such earnings. If the employer causes the employee to bear the entire cost of the deferred deduction—the global contracting model—then the only difference, to the employee, between the receipt of taxable compensation and deferred compensation is the difference between the employee's after-tax rate of return and the employer's after-tax rate of return. Professors Hall and Liebman of Harvard University analyzed the tax benefits of deferral from a “global contracting” perspective. Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, TAX POL'Y & ECON. 1, 14 (2000) (attributing the term “global contracting” to MYRON SCHOLES & MARK WOLFSON, TAXES AND BUSINESS STRATEGY (1992)). This perspective assumes that a corporation will hold its after-tax cost constant and is, therefore, indifferent between paying compensation today or investing the compensation amount for a period and paying the compensation and the cumulative returns at the end of such period. Assume that an executive could presently receive \$1 million in taxable compensation, the executive's personal marginal tax rate is  $pt$ , and the corporation's marginal tax rate is  $ct$ . The executive's and the corporation's after-tax rate of return on investments is  $rp$  and  $rc$ , respectively. If the corporation pays the compensation currently its cost, in present value terms, is the after-tax cost of the compensation, or \$1 million \*  $(1-ct)$ . If the corporation defers payment its after-tax cost in  $n$  years is  $(\$1 \text{ million} * (1+rc)^n) * (1-ct)$ . In present value terms, however, the after tax cost is  $(\$1 \text{ million} * (1+rc)^n) * (1-ct) \div (1+rc)^n$  which is exactly the same as the cost of paying the compensation in taxable form or \$1 million \*  $(1-ct)$ . For the executive, the difference between the amounts accumulated after  $n$  years under each scenario is a function of the difference between the executive's personal rate of return on investments and the rate of return earned by the corporation. An executive that received \$1 million in current compensation would accumulate, in after-tax dollars, \$1 million \*  $(1-pt)^n$  after  $n$  years. Under the deferred compensation arrangement the amount that such executive would receive is \$1 million \*  $(1-pt)^n * (1+rc)^n$ . For example, if personal tax rates are expected to decline or, due to personal idiosyncrasies, an executive can time the exercise of options in a low tax year, the benefits of the deferral will increase.

time of grant. Consequently, the transaction remains open until such options are exercised at which time the resulting income is taxed as compensation.<sup>258</sup> As a result, option exercises often lead to extraordinarily large amounts of income to the holders of options and equally large deductions to the grantor corporation.<sup>259</sup>

### 3. Incentive Stock Options

*The recipient of an incentive stock option does not recognize taxable income upon either the grant of the option or its exercise.<sup>260</sup> Instead, the incidence of taxation is postponed until the option holder disposes of the stock acquired through the exercise of the option.<sup>261</sup> Consequently, incentive stock options offer the employee the ability to defer tax indefinitely. Moreover, the tax incurred upon disposition of the stock, if such transaction results in a gain, will be taxed at capital gain rates.<sup>262</sup> Thus, these options offer, in addition to tax deferral, the ability to convert compensation income into favorably taxed capital gains.<sup>263</sup> The quid pro quo for such favorable treatment of the option*

258. Compensatory stock options issuances are rare examples of transactions that have Internal Revenue Service imprimatur for “open transaction” treatment. *See supra* note 106 and accompanying text.

259. Cisco Systems reported a tax benefit of approximately \$2.5 billion for its fiscal year ended July 2000 resulting from compensation deductions attributable to the exercise of employee stock options. *See* Michelle Hanlon & Terry Shevlin, *Accounting for Tax Benefits of Employee Stock Options and Implications for Research*, 16 ACCT. HORIZONS 1, 1-2 (2002). Legislation introduced in 2007 would alter the employer’s tax treatment of nonqualified stock options. *See supra* note 239.

260. I.R.C. § 421(a)(1) (2006). The I.R.S. has issued proposed regulations that would subject the exercise of incentive stock options to Federal Insurance Contribution Act and Federal Unemployment Tax Act tax liability. *See generally* Prop. Treas. Reg. §§ 31.3121(a)-1(k), 31.3306(b)-1(l), 31.3401(a)-1(b)(15), 66 Fed. Reg. 57023 (Nov. 14, 2001). Representative Houghton and Senator Clinton, both from New York, have sponsored legislation to prevent the imposition of payroll taxes upon exercise of incentive stock options. *See* H.R. 2695, 107th Cong. (2001); S. 1383, 107th Cong. (2001).

261. I.R.C. § 421 (a)(1) (2006). The employee’s holding period for the stock commences on the exercise date. *See* I.R.C. § 422(a) (2006). It is possible for I.R.C. § 83 to apply in situations where the stock acquired upon the exercise of incentive stock options is subject to a substantial risk of forfeiture. A recent Ninth Circuit case dealt with alternative-minimum tax issues arising from the exercise of incentive stock options for which an I.R.C. § 83(b) election was made. In that case, a portion of the shares the taxpayer received upon the exercise of the incentive stock options were subject to a substantial risk of forfeiture. The taxpayer made a § 83(b) election and, therefore, was subject to the alternative-minimum tax on the spread between the exercise price and the fair market value of the shares on all his shares, including those that were not vested. Subsequently, the taxpayer forfeited the unvested shares and sold them back to the employer at cost, thereby increasing his capital loss. *See infra* note 278.

262. *See* I.R.C. § 1222(3) (2006); David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 466-67 (2000).

263. *See* I.R.C. § 1222 (2006).



holder is the inability of the option grantor to deduct any amounts associated with the compensatory option grant.<sup>264</sup>

Internal Revenue Code Section 422 provides the statutory framework for incentive stock options.<sup>265</sup> Stringent requirements are imposed on such plans and several limitations are placed on both the grantor and option holder.<sup>266</sup> In order to qualify as an incentive stock option, the option must be granted by the employer's corporation pursuant to a shareholder-approved plan.<sup>267</sup> Options under such plans must be granted within ten years from the earlier of the date such plan is adopted or approved by the shareholders and must be exercisable within ten years from the date of grant.<sup>268</sup> The option's strike price cannot be less than the underlying stock's fair market value.<sup>269</sup> In addition, the options must be nontransferable and exercisable only by the employee.<sup>270</sup>

The aggregate fair market value of stock with respect to which such options are exercisable in any calendar year may not exceed \$100,000.<sup>271</sup> This limitation accounts for their relative insignificance as a component of executive compensation. A further restriction is placed on the option holder that restricts her flexibility in disposing of any stock acquired through exercise of such options. The holder of stock acquired through the exercise of an incentive stock option may not dispose of such shares within two years of the date the option was granted, nor within one year

264. I.R.C. § 421(a)(2) (2006).

265. See I.R.C. § 422 (b) (2006).

266. See *infra* note 267 and accompanying text.

267. I.R.C. § 422(b)(1) (2006). In the case of an affiliated group of corporations, the options may be granted by the parent corporation or any subsidiary corporation despite the fact that such issuing corporation does not employ the recipient of the option. I.R.C. § 422(b) (2006).

268. I.R.C. § 422(b)(2)-(3) (2006).

269. I.R.C. § 422(b)(4) (2006). Failure to meet this requirement will not disqualify the option if such failure resulted from a good faith attempt to value the underlying stock. I.R.C. § 422(c)(1) (2006).

270. I.R.C. § 422(b)(5) (2006). While the section does provide an exception for testamentary dispositions, there is no exception made for transfers pursuant to a divorce. *Id.* Individuals possessing more than 10 percent of the combined voting power of all classes of employer stock are ineligible to receive such options unless the option's strike price is at least 110 percent of the underlying stock's fair market value and the option is not exercisable prior to the expiration of five years from the date of its grant. I.R.C. §§ 422(b)(6), 422(c)(5) (2006).

271. *Id.* If this limit is exceeded, then the options that exceed the limit, determined by order of grant, are not eligible for incentive stock option treatment. In the event this limit is exceeded the employer should specifically state that part of the options, to the extent of the limitation, are incentive options and the excess options are nonqualified. See I.R.S. Notice 87-49, 1987-2 C.B. 355. The transfer agent should issue separate stock certificates identifying which stock was acquired through the exercise of the incentive stock options. See *id.*

after the exercise of the option.<sup>272</sup> If the option holder disposes of the stock prior to the expiration of the aforementioned period, then such option is treated as a nonqualified option and the holder recognizes income on the exercise of the option, and the employer corporation generates a deduction equal to the amount the holder recognizes as income.<sup>273</sup>

The alternative-minimum tax provides a potential burden to incentive stock option holders. A detailed discussion of the alternative-minimum tax is beyond the scope of this work. In brief, the alternative-minimum tax is imposed if the taxpayer's tentative minimum tax exceeds her regular tax liability.<sup>274</sup> The tax base, for this purpose, is the taxpayer's taxable income adjusted by certain statutorily defined items and increased for certain tax preference items.<sup>275</sup> In essence, this system was designed to ensure that taxpayers making use of favorable tax provisions incurred at least some tax liability.<sup>276</sup> The ability to defer the incidence of taxation beyond the time of the option's exercise is not available for alternative-minimum tax purposes.<sup>277</sup> As a consequence, taxpayers subject to the alternative-minimum tax lose a portion of their deferral benefits. Such taxpayers, however, are entitled to a minimum tax credit, but such credit is limited to use in years in which the taxpayer

272. I.R.C. § 422(a)(1) (2006). Moreover, the option holder must exercise such option within three months of termination of employment. I.R.C. § 422(a)(2) (2006).

273. I.R.C. § 421(b) (2006); Treas. Reg. § 1.83-7(a) (1978). If the value of the stock has decreased between the time the option was exercised and the time of the stock's disposition, then the amount the employee must include in income, and the employer may deduct, is limited to the amount realized on the sale of the stock. I.R.C. § 422(c)(2) (2006). This is favorable for the employee because it prevents the employee from recognizing a larger amount of compensation and recognizing an offsetting capital loss that may or may not be currently deductible.

274. See Warren Rojas, *Outdated AMT Claims First Victims of the 21st Century*, 91 TAX NOTES 691, 692 (2001) (describing the alternative-minimum tax with regard to incentive stock options as a tax on the amount representing the difference between the option's exercise price and the fair market value of the stock when the option is exercised).

275. See *id.* (stating that, with regard to incentive stock options, the amount representing the difference between the exercise price of the option and the fair market value of the stock when the option is exercised results in an increase in tax debt since it is subject to the alternative-minimum tax, even though the employee has not actually received any extra money).

276. For individual taxpayers, the tentative minimum tax is determined by applying a 26% tax rate to the first \$175,000 of alternative-minimum taxable income and a 28% rate to alternative-minimum taxable income in excess of \$175,000. I.R.C. § 55(b)(1)(A)(i) (2006). The alternative-minimum tax is not an "add-on" tax as such. In essence, it is an alternative tax system with reduced preferences and separate tax accounting rules. Adjustments to taxable income arising from the application of different tax accounting rules will not alter the amount of income or deduction resulting from a transaction over time but do alter the timing of the recognition of such income or deduction. A credit mechanism is in place that allows a taxpayer to recoup past alternative-minimum tax payments that resulted from such timing differences.

277. I.R.C. § 56(b)(3) (2006).

incurs only regular tax liability and its use is limited to the amount of such liability.<sup>278</sup>

The recapture of equity-based compensation from an employee by an employer pursuant to a clawback provision implicates many of the same tax issues discussed above in connection with the clawback of cash compensation. In the event that the employee has not yet realized income for tax purposes, the forfeiture of such income will have no tax consequences. For example, the forfeiture of restricted stock which has not yet vested and for which no election under I.R.C. Section 83(b) had been made will be a non-event for federal income tax purposes.<sup>279</sup> Similarly, the forfeiture of compensatory stock options will have no tax consequences.<sup>280</sup> In situations where the employee has recognized income from the receipt of property whether the subsequent forfeiture of such income allows the employee to utilize the benefits of I.R.C. Section 1341 will depend on the resolution of issues similar to those discussed above with respect to cash compensation.<sup>281</sup>

Despite the similarities in tax consequences between the forfeiture of cash compensation and equity-based compensation, there are unique

278. See I.R.C. § 55 (2006). The statutes governing the alternative-minimum tax do not address whether the capital-loss limitations imposed by I.R.C. §§ 1211 and 1212 apply for alternative-minimum tax purposes. In 2006, the Tax Court, in *Merlo v. Commissioner*, 126 T.C. 205 (2006), held that the capital-loss limitations imposed by I.R.C. §§ 1211 and 1212 do indeed apply for purposes of determining the alternative-minimum tax thereby denying the taxpayer's alternative-minimum tax net operating loss deduction. A federal district court held likewise. See *Norman v. United States*, 2006-2 U.S. Tax Cas. (CCH) P50,429, U.S. Dist. LEXIS 52,609 (N. D. Ca. 2006), *aff'd*, 2008 U.S. App. LEXIS 16207 (9th Cir. 2008). *Merlo* was affirmed by the Fifth Circuit. *Merlo v. Comm'r*, 492 F. 3d. 618 (5th Cir. 2007). The Ninth Circuit recently joined the Fifth Circuit in holding that the capital-loss limitations do indeed apply for alternative-minimum tax purposes. See *Kadillak v. Comm'r*, 534 F. 3d. 1197 (9th Cir. 2008). The Tax Extenders and Alternative-minimum tax Relief Act of 2008, part of the Emergency Economic Stabilization Act of 2008, abated all alternative-minimum tax liability, interest, and penalties resulting from the exercise of incentive stock options outstanding on October 3, 2008, and provides a limited credit for interest and penalties already paid that would have been abated had they not been paid. The Tax Extenders and Alternative-minimum tax Relief Act of 2008, Pub. L. No. 110-343, § 103(b), 122 Stat. 3765, 3864 (2008) (adding § 53(f) to the I.R.C.).

279. Property subject to substantial risk of forfeiture is not taxable until such substantial risk of forfeiture lapses. I.R.C. § 83(b) allows the property recipient to include the value of the property received in income at the time of its receipt notwithstanding the fact that is subject to forfeiture. See *supra* notes 246-248 and accompanying text.

280. So long as the exercise price of the stock options equals or exceeds the fair market value of the underlying stock on the date of the options' grant, no taxable income is recognized by the option recipient. Instead, income recognition is postponed until the options are exercised. See *supra* note 253 and accompanying text.

281. See *supra* notes 220-227 and accompanying text.

tax issues presented by the forfeiture of equity-based compensation.<sup>282</sup> As previously discussed, I.R.C. Section 83(b) allows the recipient of property subject to a substantial risk of forfeiture the option to include in income, in the year such property is received, the value of the property at the time of its receipt.<sup>283</sup> The election to accelerate the income inclusion from the receipt of property has its greatest benefit in situations where the property appreciates between the time of its grant and the time the substantial risk of forfeiture lapses.<sup>284</sup> In such cases, the recipient of the property is taxed based on the property's lower value at the time of grant and the incidence of taxation on the appreciation of the property is deferred until such time as the property is sold. Moreover, assuming the existence of favorable capital gain rates, the appreciation will be taxed at lower rates. However, the benefit of I.R.C. Section 83(b) comes at a price.

In addition to the fact that an election under I.R.C. Section 83(b) accelerates the time at which a property transaction is taxable, no deduction is available upon the subsequent forfeiture of the property.<sup>285</sup> For example, assume that an executive was granted 10,000 shares of employer stock with a fair market value of \$500,000 in 2009. Under the terms of the grant, the stock vests if certain performance metrics are met for the employer's fiscal year ending June 30, 2010. If the executive makes the I.R.C. Section 83(b) election she will recognize \$500,000 of income in 2009. In the absence of such an election and assuming that the performance metrics are met, she will recognize compensation

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282. Generally, the forfeiture of nonqualified stock options will not create any tax consequences because the recipient of the options is not taxed at the time the options are granted or vested. Instead, the incidence of taxation is postponed until such time as the options are exercised. *See supra* note 253 and accompanying text. However, if the option itself were subject to tax because it had a readily ascertainable fair market value, then the tax consequences that would result from forfeiture of the options would be similar to those that would result from the forfeiture of the underlying stock itself. *Id.*

283. *See supra* notes 246-248 and accompanying text.

284. Assuming constant income tax rates, the election will prove beneficial so long as the property appreciates at a rate that compensates the recipient for the time value of the funds used to pay the tax earlier than necessary. In the event that tax rates decrease between the time that the property is received and the time that the substantial risk of forfeiture lapses, the property will have to appreciate at a rate sufficient to compensate for both the time value of money and the differential in the tax rate in order for the election to have been worthwhile. In the event that tax rates increase between the time the property is received and the time the substantial risk of forfeiture lapses, the property will have to appreciate at a rate sufficient to compensate for the time value of money less the differential in the tax rate in order for the election to have been worthwhile.

285. I.R.C. § 83(b)(1) (2006). In the event that the recipient of property paid for the property, a capital loss is recognized upon the property's forfeiture in an amount equal to the amount paid for the property less any amount realized upon the property's forfeiture. *See* Treas. Reg. § 1.83-2(a) (1978).

income in 2010 equal to the value of the stock on the date of vesting in 2010. If the election is made and the performance metrics are not met, then no deduction is permitted in 2010 when the stock is forfeited. Consequently, the employee will recognize \$500,000 of income which she will not receive. Section 1341 provides no relief in this situation for two reasons. First, Section 1341 requires that the amount in question be deductible, which, due to Section 83(b), it is not.<sup>286</sup> Second, the employee has no apparent right to the income in the year of the election.<sup>287</sup> A Section 83(b) election causes the employee to recognize income in the face of a substantial risk of forfeiture. At the time of the election the employee is fully aware of such risk and, therefore, cannot claim that such income was received under an apparent claim of right.

Less clear is the result that arises if the forfeiture occurs due to a restatement of the metrics after the stock purportedly vested. Assume, for example, that the performance metrics for the fiscal year ended June 30, 2010 were met. As a result, the stock award vested. Assume further, however, that the results of fiscal year 2010 are restated at some point in 2011 and that the performance metrics, after restatement, are not met, triggering a clawback of the stock. It is not clear whether the deduction prohibition of I.R.C. Section 83(b)(2) applies in this situation. An argument can be made that the stock award vested and, therefore, Section 83(b) no longer controls. Alternatively, had the metrics been measured properly, the stock would have never vested thereby triggering the deduction prohibition pursuant to I.R.C. Section 83(b)(2). The regulations issued under I.R.C. Section 83 would appear to favor the former argument.

In effect, two risks of forfeiture are present. The first risk is that the performance metrics are not met. This clearly is deemed a substantial risk of forfeiture under the regulations. The second risk is that, after vesting, the clawback provision is triggered due to some event, such as a restatement of the metrics. This would not appear to be a substantial risk of forfeiture under the regulations.<sup>288</sup> In the event the property recipient did not make the I.R.C. Section 83(b) election, she would have been subject to tax on the receipt of the property in 2010 and the risk of forfeiture due to possible restatement would have been

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286. See *supra* note 179 and accompanying text.

287. See *supra* note 178 and accompanying text.

288. The regulations do not deal expressly with the possibility of restatements. However, the examples provided indicate that events that do not commonly occur or that are subject to the control of the employee are not considered substantial risks of forfeiture. See *generally* Treas. Reg. § 1.83-3(b)(2) (2005).

ignored. Therefore, if the property would have been subject to tax under Section 83 in any event prior to its forfeiture, then any loss due to such forfeiture should fall outside the scope of I.R.C. Section 83(b)'s deduction prohibition.

Despite the fact that the forfeiture of compensation under these circumstances may be deductible notwithstanding Section 83(b), it would appear that I.R.C. Section 1341 relief would, nonetheless, be unavailable. If no I.R.C. Section 83(b) election was made, then I.R.C. Section 1341 could potentially be applicable because at the time the income was received the recipient had an apparent right to such income.<sup>289</sup> However, accelerating the income to a time when the property received was subject to a substantial risk of forfeiture would appear to preclude any notion that the recipient had an apparent right to the income. In the above example, the employee may have had an apparent right to the stock in 2010 but certainly did not have any right, apparent or otherwise, to the stock in 2009 when its value was included in income. Section 1341 appears to be of no use in cases where the original incidence of taxation was accelerated due to a Section 83(b) election. In the event the property is forfeited due to its failure to vest, Section 1341 would be inapplicable because no deduction is allowed for the forfeiture. In the event the property vests but is later forfeited, Section 1341 would be unavailable because the income was originally recognized while it was subject to a substantial risk of forfeiture and, thus, the recipient had no apparent right to such income.

The forfeiture of equity compensation also raises issues regarding the nature of the forfeiture transaction for tax purposes. In the event that a Section 83(b) election is in effect and the property is forfeited while such property is subject to a substantial risk of forfeiture, the tax consequences are straightforward. No deduction is available to the employee upon the forfeiture of the property and any capital loss is limited to the excess of the amount paid, if any, for the property by the employee over the amount realized by the employee upon the property's disposition.<sup>290</sup> However, if the property has substantially vested prior to forfeiture, these rules are inapplicable.<sup>291</sup> Consequently, a deduction should be available to the employee. However, unlike the repayment of cash compensation, the tax consequences of the forfeiture of equity-flavored compensation are not so predictable. It is very unlikely that the

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289. See *supra* note 178 and accompanying text.

290. See *supra* note 247 and accompanying text.

291. See *supra* notes 288-289 and accompanying text

value of the shares forfeited will be equal to their value at the time such shares were included in income. Conceivably, the forfeiture of the shares represents a sale or exchange of the shares in settlement of a liability to the employer resulting in a deduction in an amount equal to the value of the shares at the time of forfeiture and a capital gain or loss equal to the subsequent appreciation or depreciation, as the case may be, of the shares. For example, assume that an employee received shares worth \$100,000 at the time they substantially vested and were included in income. One year later the shares are forfeited when they are worth \$125,000. Arguably, the employee is entitled to a \$125,000 deduction accompanied by a \$25,000 capital gain.<sup>292</sup> However, the regulations make clear that any loss that occurs from a forfeiture after the property has substantially vested is an ordinary loss equal to the amount that the employee included in income.<sup>293</sup> Consequently, in the above example, the employee would be entitled to an ordinary loss of \$100,000.

In the event that the clawback extends to the profit generated from the sale of stock, then the *Arrowsmith* doctrine would come into play.<sup>294</sup> Consequently, the executive would realize a capital loss on the repayment of such profits. Due to the limitations on the use of capital losses, the applicability of Section 1341 is of heightened importance in such situations. Whether the benefits of Section 1341 are available will depend on the circumstances surrounding the clawback and whether such circumstances allow for the application of this provision.

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292. Under the regulations a forfeiture of property while such property is substantially non-vested is treated as a sale or exchange of the forfeited property for which any loss realized is limited to the excess of the amount paid for the property over the amount realized upon the forfeiture. However, these regulations apply to forfeitures of substantially non-vested property for which a I.R.C. § 83(b) election was made. See Treas. Reg. § 1.83-2(a) (1978).

293. Treas. Reg. § 1.83-1(e) (2003). In the event that the employee paid for the property, any loss attributable to the amount paid would be a capital loss. The regulations deal explicitly only with the amount of basis attributable to the employee's income inclusion. It would appear that the approach taken by Treas. Reg. § 1.83-2(a), discussed at *supra* note 292, would apply in the event that substantially vested property is forfeited and that a capital loss would realized upon forfeiture equal to the excess of the amount paid for the property over the amount realized upon forfeiture. Therefore, if the stock forfeited were acquired pursuant to the exercise of a nonqualified stock option, then the loss attributable to the exercise price of the option would be a capital loss. The loss attributable to the stock's basis that resulted from the income inclusion caused by the exercise of the option would be an ordinary loss.

294. See *supra* notes 153-164 and accompanying text. The Sarbanes-Oxley Act of 2002 expressly covers such profits. See *supra* note 38 and accompanying text. It is quite possible that contractual clawback provisions could also cover such profits.

Incentive stock options are often used as a compensation vehicle for lower-level management and other personnel.<sup>295</sup> As previously discussed, incentive stock options are favorably taxed to their recipients but are subject to significant limitations that are not applicable to non-qualified options. Similar to non-qualified stock options, incentive stock options may be subject to conditions that create a substantial risk of forfeiture.<sup>296</sup> Moreover, it appears that the language in the regulations is broad enough to allow these instruments to be subject to clawback provisions.<sup>297</sup> For regular income tax purposes, the forfeiture of incentive stock options poses little difficulty. In the event that the incentive stock option is forfeited prior to exercise, its forfeiture is a non-event, for tax purposes. The grant of the option is not taxable and, therefore, its forfeiture has no income tax consequences.<sup>298</sup> Likewise, forfeiture prior to exercise would not implicate any alternative-minimum tax issues because this tax is implicated only upon the exercise of the incentive stock option.<sup>299</sup>

Forfeiture of stock acquired by the exercise of an incentive stock option would not yield any deduction to the employee because, unlike non-qualified options, the exercise of incentive stock options does not generate any compensation income.<sup>300</sup> Therefore, upon forfeiture of the stock the employee would realize a capital loss equal to the difference between the amount of the employee's basis in the stock and the amount realized upon its forfeiture. Among the requirements for the application of the favorable tax rules enjoyed by holders of incentive stock options

295. The annual \$100,000 limitation on the aggregate fair market value of stock with respect to which incentive stock options are exercisable limits their utility as a tool for compensating upper management. *See supra* note 278 and accompanying text.

296. *See* Treas. Reg. § 1.422-5(d)(1) (2004).

297. The regulations provide that “[a]n option does not fail to be an incentive stock option merely because the option is subject to a condition . . . .” *Id.* Given the limitations on the amounts that may be granted under incentive stock option plans, it is not all that common for incentive stock options to be subject to clawback provisions. These instruments are commonly issued to middle management and rank and file employees and, although they may be subject to vesting restrictions, it is rare for issuances to these employees to be conditioned on performance metrics. Note that in order for an option to qualify as an incentive stock option it must, among other requirements, be exercised while the option holder is an employee or have been exercised no later than three months after the option holder's termination of employment. The three-month grace period is extended to one year in the event the option holder's employment ceased due to permanent and total disability. Treas. Reg. §§ 1.422-1(a)(1)(i)(B); 1.422-1(a)(3) (2004).

298. *See supra* note 279 and accompanying text.

299. Unlike non-qualified stock options, the exercise of incentive stock options is not a taxable event for regular income tax purposes. However, the difference between the fair market value of the underlying shares and the options' exercise price is taxable for alternative-minimum tax purposes. *See supra* note 277 and accompanying text.

300. *See supra* notes 260-261 and accompanying text



is that the stock acquired through the exercise of the option not be disposed of prior to two years after the grant of the option and one year after the exercise of the option.<sup>301</sup> Although the regulations do not expressly address it, it would appear that a forfeiture within this period would be considered a disqualifying disposition. A disqualifying disposition would result in the option being subject to tax under the general rules of Section 83 and recognition of compensation income in the year of such disqualifying disposition.<sup>302</sup> Under general rules, the forfeiture would cause the option holder to recognize compensation income that would be offset by a concomitant deduction as a result of the forfeiture.<sup>303</sup> However, the regulations contain a special rule that prevents this result. Under this rule, the amount of compensation income to be recognized by the employee upon a disqualifying disposition is limited to the amount of gain recognized by the employee upon the disposition.<sup>304</sup> Because it is very unlikely that any gain would result from such forfeiture, no compensation income—nor related deduction—would be recognized by the employee upon such a forfeiture.

The application of the alternative-minimum tax complicates the tax consequences of forfeitures of incentive stock options. The spread between the fair market value of the stock and the exercise price of the incentive stock option at the time of exercise is taxable for alternative-minimum tax purposes.<sup>305</sup> Thus, for alternative-minimum tax purposes, these instruments resemble non-qualified stock options. Forfeiture of incentive stock options prior to their exercise would create no alternative-minimum tax consequences because the grant of such options is not taxable for alternative-minimum tax purposes.

However, unlike the consequences for regular income tax purposes, forfeiture of the stock acquired through the exercise of incentive stock options creates tax consequences similar to those encountered from the forfeiture of stock acquired through the exercise of non-qualified stock options.<sup>306</sup> Consequently, in the absence of a Section 83(b) election,

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301. See *supra* note 272 and accompanying text.

302. See Treas. Reg. § 1.421-2(b)(1) (2004).

303. Neither the rescission doctrine nor the *Merrill* doctrine would appear to apply in this case. These doctrines have limited application and the acquisition of stock through the exercise of an option, and the subsequent forfeiture of that stock, does not constitute the rescission of a contract. Moreover, the *Merrill* doctrine applies to income erroneously received and acknowledged as such in the same taxable year as its receipt. See *supra* notes 125-129 and accompanying text.

304. See Treas. Reg. § 1.422-1(b)(2)(i) (2004).

305. See *supra* note 277 and accompanying text.

306. See *supra* notes 279-294 and accompanying text.

forfeiture of the stock would lead to a deduction, for purposes of the alternative-minimum tax, as a result of the forfeiture. The benefit of this deduction may be illusory, however. If the taxpayer is not subject to the alternative-minimum tax, then no direct current benefit would be obtained from the deduction. Such a deduction may, however, increase the amount of the minimum tax credit available against the taxpayer's regular tax liability.<sup>307</sup> The minimum tax credit is available to offset a taxpayer's regular tax liability but is limited to an amount equal to the excess of the taxpayer's regular tax liability over the amount of the taxpayer's tentative minimum tax.<sup>308</sup> In effect, the credit will reduce the taxpayer's regular tax liability up to the point where any further reduction would trigger the alternative-minimum tax. As result, a deduction that reduces the tentative minimum tax has the effect of increasing the available credit for regular tax purposes.<sup>309</sup>

Under the appropriate circumstances the taxpayer may also make use of Section 1341 whose benefits are broad enough to encompass the alternative-minimum tax.<sup>310</sup> If the taxpayer made a Section 83(b) election for alternative-minimum tax purposes then, for reasons similar

307. Many of the differences between the tax bases for regular tax and alternative-minimum tax purposes result from timing differences in the recognition of income or expenses. Consequently, it is possible that taxpayers will incur a minimum tax liability in certain years and then incur a regular tax liability for the same items in later years. The minimum tax credit is the mechanism by which attempts to ameliorate this result. *See generally* I.R.C. § 53 (2006). In effect, the minimum tax credit converts the alternative-minimum tax, at least in part, to a prepayment of the regular tax. Timing differences are not tracked individually and, therefore, the minimum tax credit does not neatly track the exact effects of timing differences. For example, it is irrelevant, for purposes of determining the availability of the credit, whether the timing differences that created the credit reversed themselves in the year in which the credit is used. *Id.*

308. *See* I.R.C. § 53(c) (2006). Notwithstanding the general limitation, a special rule allows taxpayers to use a minimum amount of long-term credits for tax years ending before 2013. *See* I.R.C. § 53(e) (2006).

309. Intuitively, this result is appropriate. To the extent that the exercise of the options in an earlier year resulted in alternative-minimum tax liability, the subsequent forfeiture of the gains from those options should result in recoupment of that tax liability—in this case through an increase in the minimum tax credit.

310. I.R.C. § 1341 is applicable to any taxes imposed by Chapter 1 of the Internal Revenue Code. I.R.C. § 1341(a) (2006). The alternative-minimum tax is imposed under Chapter 1, Subchapter A, Part VI. The application of I.R.C. § 1341 is muddled by the alternative-minimum tax credit. It is quite possible that all or a portion of the alternative-minimum tax imposed in an earlier year has already been recouped in a subsequent year or years through the use of alternative-minimum tax credit. *See supra* note 278. It would appear inappropriate for a taxpayer to be able to recoup the alternative-minimum tax paid in the year the options were exercised in toto without reduction for the amount of such already recouped in a subsequent year. The statutory language is broad enough to prevent this result. Section 1341 yields a reduction in tax for the current year in an amount equal to the decrease in tax for the prior year or years which would result from the exclusion of the gain from the exercise of incentive stock options. *See* I.R.C. § 1341(a)(5)(B) (2006) (emphasis added).

to those previously discussed with respect to forfeitures of stock acquired through the exercise of non-qualified stock options, no deduction would be available upon the forfeiture of the stock and, accordingly, the benefits of Section 1341 would be unavailable.<sup>311</sup>

#### IV. CONCLUSION

Compensation clawback provisions are proliferating. The Sarbanes-Oxley Act of 2002 provided for the clawback of certain forms of compensation but limited its reach to a small number of executive officers of publicly traded entities and required the intervention of the Securities and Exchange Commission for enforcement. The rapidity with which large financial institutions met their demise—or averted such demise due to government largess—has prompted a reassessment of incentive compensation structures that many commentators believe encouraged excessive leverage and imprudent short-term risk taking. Legislation enacted in late 2008 and early 2009 mandated clawback provisions in executive compensation arrangements for firms receiving federal financial assistance. Moreover, shareholders and directors, emboldened by the recent chain of events, have begun demanding greater accountability from their executives resulting in the implementation of clawback provisions in industries far removed from Wall Street and the financial sector. Whether clawback provisions will lead to greater prudence on the part of management or stifle creativity remains to be seen. However, these provisions strike the public at large as a common-sense approach to achieve a measure of fairness.

The federal income tax consequences to executives forced to repay or forfeit compensation is complicated—and not entirely fair. The tax consequences of repaid or forfeited compensation are dependent upon

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311. See *supra* note 247 and accompanying text. An election pursuant to I.R.C. § 83(b) is not available, for regular tax purposes, for incentive stock options because such instruments are not taxable under I.R.C. § 83. However, because, for alternative-minimum tax purposes, incentive stock options are taxable upon exercise, such an election is permissible for purposes of the alternative-minimum tax. See Treas. Reg. § 1.422-1(b)(3), *Example 2* (2004). Such an election exposes the taxpayer to the prohibition on the deduction of losses resulting from the forfeiture of the stock. See *supra* note 247 and accompanying text. Although such a result may cause the taxpayer to have a larger capital loss on the forfeiture, the courts have held that the capital-loss limitations applicable to the calculation of the regular tax liability apply for alternative-minimum tax purposes. See *supra* note 278. See *id.* for a discussion of the moratorium on the collection of alternative-minimum tax liability resulting from the exercise of incentive stock options. Note that if the incentive stock options were no longer subject to a substantial risk of forfeiture but were forfeited pursuant to a clawback provision a deduction would be available for alternative-minimum tax purposes. However, I.R.C. § 1341 would be inapplicable if an election under I.R.C. § 83(b) were in effect. See *supra* note 289 and accompanying text.

the federal income tax treatment of the compensation subject to the clawback. The annual accounting concept virtually assures that the tax benefits derived from the deduction that results from the clawback will not correspond to the tax burden imposed upon the executives in the year the compensation was received. I.R.C. Section 1341, an ameliorative provision, may or may not apply depending upon the particular circumstances surrounding the clawback. With respect to equity-based incentive compensation executives will have to rethink the desirability of the I.R.C. Section 83(b) election. Although the decision to make such election has always required careful analysis, the potential that such compensation may be clawed back adds another, quite significant, factor to consider. The benefits of I.R.C. Section 1341 will not apply to compensation for which such an election was made.

The potential that executives will fail to come close in recouping the taxes paid on compensation that they cannot retain may result in longer deferrals of incentive compensation. The forfeiture of untaxed compensation may be relatively less painful, from both a psychological and tax standpoint, than the repayment of previously taxed income. To borrow from a famous adage: In the case of compensation it is not better to have been paid and lost than not to have been paid at all.

