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Executive Pay Clawbacks and Their Taxation

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EXECUTIVE PAY CLAWBACKS AND THEIR TAXATION

by

David I. Walker*

ABSTRACT

Executive pay clawback provisions require executives to repay previously received compensation under certain circumstances, such as a downward adjustment to the financial results upon which their incentive pay was predicated. The use of these provisions is on the rise, and the SEC is expected to soon finalize rules implementing a mandatory, no-fault clawback requirement enacted as part of the Dodd-Frank legislation. The tax issue raised by clawbacks is this: should executives be allowed to recover taxes previously paid on compensation that is returned to the company as a result of a clawback provision? This Article argues that a full tax offset regime is most in keeping with the evolving rationales for clawbacks, with consistent treatment of executives subject to clawbacks, with encouraging even-handed implementation of clawbacks, and with minimizing clawback-induced distortions and other unintended consequences associated with a tax regime that would not provide full offsets. But the tax treatment of clawback payments has been uncertain, and the enactment of the Tax Cuts and Jobs Act adds to that uncertainty. Meanwhile, adoption of legislation to ensure that executives are fully compensated for taxes previously paid on recouped compensation is probably a political non-starter. Given that, this Article argues that the IRS and courts should interpret the

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relevant tax laws liberally to maximize recovery of taxes paid on clawed back compensation.

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I. INTRODUCTION

Executive pay clawback provisions require executives to forfeit previously received compensation under certain circumstances, most notably after a downward adjustment to the financial results upon which their incentive compensation was predicated. Clawback provisions are on the rise. Limited clawbacks were mandated under the Sarbanes-Oxley Act of 2002 (SOX).¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) mandated a much more comprehensive no-fault clawback regime,² and the SEC is in the process of finalizing rules to implement the Dodd-Frank clawback.³ Meanwhile, the fraction of S&P 1500 companies proactively adopting clawback provisions more expansive than those mandated by SOX increased from

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter SOX] (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) [hereinafter Dodd-Frank].

3. The SEC released proposed rules implementing the Dodd-Frank clawback on July 1, 2015. See Listing Standards for Recovery of Erroneously Awarded Compensation, Dodd-Frank Act Release No. 33-9861, 80 Fed. Reg. 41,144 (July 15, 2015), <https://www.sec.gov/rules/proposed/2015/33-9861.pdf> [https://perma.cc/89NV-M8TF] [hereinafter SEC Release].

less than 1% in 2004 to 62% in 2013,⁴ and a recent report indicates that more than 90% of the 1000 largest companies have disclosed that they have adopted clawback policies of one sort or another.⁵

This Article focuses on the federal income tax consequences of clawbacks, specifically on the tax treatment of repayments by executives in cases in which the compensation repaid has been included in taxable income in a prior year. This is surprisingly under-explored terrain,⁶ particularly given that individual taxes can consume as much as 50% of executive compensation.

4. Ilona Babenko et al., *Clawback Provisions and Firm Risk* 42 (Apr. 30, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3382498 [<https://perma.cc/7S78-FCJ9>] [hereinafter BBBCS].

5. Joshua A. Agen, *Compensation Clawbacks: Trends and Lessons Learned*, FOLEY (Oct. 21, 2020), <https://www.foley.com/en/insights/publications/2020/10/compensation-clawbacks-trends-and-lessons-learned> [<https://perma.cc/SG8F-HX58>].

6. Several law review articles have addressed clawback provisions from a corporate governance perspective, either as their primary focus, e.g., Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721 (2011); Jesse M. Fried, *Rationalizing the Dodd-Frank Clawback* (Eur. Corp. Governance Inst., Law Working Paper No. 314/2016, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2764409 [<https://perma.cc/P3DU-A7KG>]; John Patrick Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005, 1017–19 (2004); or at least in passing, e.g., Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1806–07 (2011); Steven A. Bank & George S. Georgiev, *Paying High for Low Performance*, 100 MINN. L. REV. HEADNOTES 14, 23–27 (2016); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-term*, 26 YALE J. ON REG. 359, 366 (2009); Kevin J. Murphy & Michael C. Jensen, *The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation* 41 (USC Law Legal Studies Paper No. 18-8, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3153147 [<https://perma.cc/FP5N-25H4>]. Meanwhile, a number of researchers from the finance and accounting disciplines have investigated the implications of clawback provisions for firm value and risk. E.g., BBBCS, *supra* note 4; Tor-Erik Bakke et al., *The Value Implications of Mandatory Clawback Provisions* (June 28, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2890578 [<https://perma.cc/8LW6-J442>]. To date, however, there has been little academic discussion of the tax policy implications of clawbacks. Exceptions include Rosina B. Barker & Kevin P. O'Brien, *Taxing Clawbacks: Theory and*

Imagine the following scenario. In 2019, Executive receives a \$1 million cash bonus based on the Company's achievement of a certain earnings target. In 2020, the Company restates and reduces 2019 earnings. Based on the restated earnings, Executive would have been entitled to a \$700,000 bonus for 2019, and under the Dodd-Frank clawback regime, the Executive is required to repay \$300,000 to her Company. Assuming that the *Company* was able to deduct the payment in 2019, it will be required to include the repaid amount in taxable income for 2020. Executive will have included and paid tax on \$1 million of compensation in 2019. Should she receive a deduction in 2020 for the \$300,000 repayment? Should the answer depend on whether Executive signed off on the 2019 earnings figure? On whether Executive "cooked the books" herself or enlisted an underling to do so? What if a deduction is allowed but, due to various limitations discussed below, fails to make Executive whole for the taxes incurred on the repaid compensation? Should additional relief be available?

These are very real, and with implementation of the mandatory, no-fault, Dodd-Frank clawback looming, likely soon to be very pressing issues. This Article considers these questions, focusing first on what the tax rules optimally should be. I conclude that optimally executives should be made whole for taxes paid on compensation that is subsequently repaid as a result of a clawback provision. This result is dictated most strongly if the underlying rationale for clawbacks is prevention of unjust enrichment and/or facilitating the management of executive risk-taking incentives. If the primary goal of clawbacks is to minimize the payoffs to and thus the amount of financial misreporting, one could argue that deductibility of clawback repayments is unnecessary and possibly even counterproductive. Even in this case, however, the risk of mistake and false positives weighs in favor of refunding previously paid tax.⁷

But there are other reasons to prefer a clawback tax regime providing full recovery of tax paid on compensation that is

Practice, 129 TAX NOTES 423 (Oct. 25, 2010); and Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation*, 25 AKRON TAX J. 55 (2010). Although not directly aimed at clawback provisions, Professor Douglas Kahn has recently published a highly relevant article in *Tax Notes*: Douglas A. Kahn, *Return of an Employee's Claim of Right Income*, 163 TAX NOTES FED. 1819 (June 17, 2019).

7. *Infra* Part III.C.

subsequently returned. First, a full tax offset approach will provide consistent tax treatment of executives irrespective of their decision to defer compensation and tax and will avoid punishing innocent executives forced to repay compensation under no-fault clawback regimes. Second, executives and firms are less likely to voluntarily adopt comprehensive and meaningful clawback provisions, or to fairly enforce mandatory clawback obligations, if the tax treatment is asymmetric; that is, if taxes are not fully refunded when compensation is repaid, and to the extent that taxes are not fully refunded, we can expect that executives will demand to be compensated for the tax risk.⁸ Third, whether mandated or voluntarily adopted, the existence of clawback provisions may distort the design of executive pay, and asymmetric tax treatment of repayments may amplify those distortions. When these additional effects are considered, the case for refunding becomes stronger, whatever the rationale for clawback adoption.⁹

How does present tax law match up? It's complicated, but in a nutshell, repayment of clawed back compensation generally should be deductible by executives as ordinary and necessary business deductions under I.R.C. § 162 or as business losses under § 165. But basic deductibility is only one part of the equation. The §§ 162/165 deduction for clawed back compensation is a miscellaneous itemized deduction (MID). Prior to 2018, MIDs were deductible only to the extent that they exceeded 2% of AGI, were not deductible for purposes of the alternative minimum tax, and were, along with other itemized deductions, phased down for high income taxpayers under I.R.C. § 68. As a result, a deduction for compensation repaid was unlikely to make an executive whole for taxes paid on that compensation in prior years. The basic deductibility picture became clearer, but much worse, with the passage of the Tax Cuts and Jobs Act (TCJA). Under that legislation, MIDs are simply not deductible for tax years 2018 through 2025. So, as far as we have gone, there would be no effective deduction for compensation clawed back in any of the next several years.¹⁰

8. Compensation could take the form of ex ante increases in pay to offset the tax risk or tax “gross up” payments in the event that clawbacks do not result in full refunds of previously paid tax. This Article considers both possibilities.

9. *Infra* Part III.C.2.

10. *Infra* Part IV.A.

But that brings us to I.R.C. § 1341, a provision that can make taxpayers whole for repayments of amounts received under a “claim of right” that are later repaid. When it applies, § 1341 provides a non-miscellaneous itemized deduction (still deductible under the TCJA) equal to the value of the current year deduction under §§ 162/165 or, if more valuable, a tax credit equal to the reduction in tax in prior years that would have occurred had the recouped compensation never been included in income in the first place.¹¹

The bottom line here is that § 1341 could be applied to executive pay clawbacks to get to the right result, or close to the right result, in most cases. However, there is a significant risk that it will be applied in such a way as to bar recovery in an excessive number of cases. Ideally, Congress or the Treasury would amend § 1341 or the regulations thereunder to make it clear that executives should be made whole for taxes paid on clawed back compensation, but this may be unlikely in the present environment. Moreover, there is a concern about optics. Allowing deductions for repaid compensation, particularly in cases in which the executive doing the repaying is at fault, looks like a tax subsidy for bad behavior. It isn’t a subsidy, but if clawbacks become frequent and if executives succeed in employing § 1341 to recoup the tax paid on clawed back compensation, it would not be surprising if one or more members of Congress proposed legislation to bar such deductions. Perhaps the best we can hope for is that the courts will construe § 1341 liberally to allow deduction and that Congress and the Treasury will do nothing.

The remainder of the Article is organized as follows. Part II provides an overview of clawback provisions, including existing and forthcoming legislatively mandated clawbacks as well as provisions that companies have voluntarily adopted. This Part highlights a shift from clawbacks apparently aimed at deterrence of financial misreporting to prevention of unjust enrichment. Part III considers from several perspectives how clawback payments should ideally be taxed and concludes that the optimal regime would allow executives full recovery of taxes previously paid on returned funds. Part IV explores the current taxation of clawed back compensation. It argues that full recovery of taxes previously paid on clawed back compensation should be available under I.R.C. § 1341 for executives who are not culpable, but that there is a great deal of uncertainty, including uncertainty resulting from the enactment of the Tax Cuts and Jobs Act. Part V briefly pulls together

11. *Infra* Part IV.B.

the previous Parts, arguing that, while the most probable tax treatment under § 1341 is roughly consistent with clawback rationales, a tax regime ensuring full offset of previously paid tax would be superior. Part VI briefly considers two other possible responses to asymmetric tax treatment of clawbacks: increased use of deferred compensation and associated issues under I.R.C. § 409A and the possibility of reducing an executive's future compensation in lieu of actually clawing back compensation. Part VII concludes and very briefly highlights the political economy impediments to enacting legislation that would ensure full recovery of taxes previously paid on recouped compensation.

II. CLAWBACK PROVISIONS: SOURCES, DESIGN, AND RATIONALES

This Part provides a brief look into the sources, design, and rationales behind executive pay clawbacks. First, I explore the clawback regimes mandated under SOX, the Troubled Asset Relief Program under the Emergency Economic Stabilization Act of 2008 (TARP), and Dodd-Frank. Then I consider the features of clawback arrangements voluntarily adopted by public companies. Finally, I consider rationales for clawback adoption or imposition, both what Congress and firms have said in adopting clawbacks and what the design elements implicitly tell us about rationales. The rationales matter when it comes to thinking about the appropriate clawback tax rules, and I will argue that more recent clawback regimes reflect a shift in focus from curtailing financial misreporting to preventing unjust enrichment of executives.

A. Clawback Legislation

Over the last twenty years, three pieces of federal legislation have been enacted that impose executive pay clawback obligations on public companies: SOX,¹² TARP,¹³ and Dodd-Frank.¹⁴ The clawback provisions in these statutes vary in terms of the events that trigger a clawback obligation, the population of executives that is covered, the types of compensation that are included, the amount of compensation that may be clawed back, and enforcement mechanisms.

12. SOX, *supra* note 1, § 304.

13. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, tit. I, 122 Stat. 3765, 3767 (2002) [hereinafter TARP].

14. Dodd-Frank, *supra* note 2, § 954.

1. SOX

Enacted in the wake of accounting frauds at Enron, Worldcom, and other firms, SOX § 304 provides that, in the event of an accounting restatement due to material noncompliance with financial reporting requirements resulting from misconduct, an issuer's CEO and CFO "shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" by the CEO or CFO within the 12-month period following the filing of the financial statement that gave rise to the restatement and to profits on company stock sold within the same period.¹⁵ Misconduct on the part of the CEO/CFO is not required to trigger the SOX clawback; it is sufficient that some misconduct within the organization led to restatement.¹⁶

The SOX clawback reaches any incentive or equity-based compensation received by a restating firm's CEO/CFO within the prescribed period, not just the excess pay attributable to the erroneous financial report. However, there is no private right of action under SOX § 304. Enforcement is solely in the hands of and at the discretion of the SEC. That discretion was used somewhat sparingly during the first five to ten years following SOX enactment, but the SEC apparently has increased § 304 enforcement activities in recent years, in some cases holding CEOs and CFOs strictly liable for accounting fraud occurring on their watch.¹⁷

2. TARP

Between 2008 and 2014, in the wake of the 2007/2008 financial crisis, the Treasury purchased "troubled" assets from a number of major financial institutions and held ownership stakes in these institutions.

15. SOX, *supra* note 1, § 304(a).

16. SEC v. Jensen, 835 F.3d 1100 (9th Cir. 2016); *see also* SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010); Anne E. Moran, *Reasonable Compensation*, 390-6th TAX MGMT. PORT. (BNA) § XIV.A, at n.712.

17. Stuart Gelfond & David Hennes, *Sarbanes-Oxley Section 304: A Sharper Tool in the Enforcement Toolbox*, CORP. BOARD MEMBER MAG., 2d qtr., 2010 (noting that the SEC brought only 10 enforcement actions under § 304 between 2002 and 2008 and that these actions all involved CEO or CFO misconduct but highlighting the SEC's later adoption of "a more expansive view of liability").

During the period in which the U.S. was directly invested in these institutions, TARP § 111 directed the Treasury Secretary to require that the institutions adopt certain corporate governance and compensation policies, including “a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate.”¹⁸

The TARP clawback applied to the top five most highly compensated executives of public and private companies.¹⁹ Unlike the SOX clawback, the TARP clawback was not predicated on misconduct. Moreover, it was not predicated explicitly on an accounting restatement, although presumably situations in which earnings are later proven to be inaccurate would generally correspond with restatements. It is somewhat unclear whether a clawback of a bonus “based on” an inaccurate statement of earnings would entail recovery of the entire bonus or only of the portion of the bonus associated with the over-reported earnings. In any event, now that all TARP positions have been unwound, the TARP clawback is no longer in force.

3. *Dodd-Frank*

A much more expansive clawback mandate was promulgated in Dodd-Frank § 954. That section, codified as § 10D of the Securities Exchange Act of 1934 (SEA), requires the SEC to direct the national securities exchanges to prohibit the listing of any security of an issuer that fails to adopt a clawback policy with certain features or to properly disclose that policy.

Dodd-Frank compliant clawbacks are triggered by financial restatements arising from material noncompliance with financial reporting requirements and require issuers to “recover from any . . . current and former executive officer(s) [of the issuer] who received incentive-based compensation (including stock options awarded as compensation) during the three-year period” preceding the restatement the amount of that compensation in excess of the amount that would

18. TARP, *supra* note 13, § 111(b)(2)(B).

19. *Id.* § 111(b)(3).

have been paid but for the erroneous financials.²⁰ This is a no-fault clawback that applies irrespective of any misconduct.

Dodd-Frank § 954 is not self-implementing but requires an SEC rule. The SEC proposed such a rule, 10D-1, in 2015. The proposed rule tracks § 954, of course, and expands upon and explains its various provisions, detailing, for example, exactly which executives and what types of compensation are subject to the clawback²¹ and how firms should go about determining the amount of excess compensation to be clawed back following a restatement.²²

Proposed rule 10D-1 has not yet been implemented. The Financial CHOICE Act of 2017 would have amended SEA § 10D to limit the application of the Dodd-Frank clawback to “such executive officer[s] who] had control or authority over the financial reporting that resulted in the accounting restatement,”²³ but the CHOICE Act did not become law. Presumably, the SEC will soon finalize the Dodd-Frank clawback rules. In a 2018 speech, then SEC Chairman Jay Clayton noted the “serial” approach the SEC was taking with respect to the rollout of the Dodd-Frank executive pay mandates, his satisfaction with the Dodd-Frank mandated CEO pay ratio rules adopted in 2015, and discussions within the commission regarding “how best to address the remaining mandatory executive compensation rules,” i.e., the Dodd-Frank clawback provision.²⁴

B. Employer-Initiated Clawbacks

The number of U.S. public companies voluntarily adopting clawback policies has increased dramatically over the last two decades. Babenko, Bennett, Bizjak, Coles, and Sandvik (BBBCS) analyzed data gleaned from proxy statements of S&P 1500 companies between 2000 and

20. Dodd-Frank, *supra* note 2, § 954, codified at Securities Exchange Act of 1934 § 10D(b), 15 U.S.C. § 78j-4.

21. SEC Release, *supra* note 3, at 32, 38.

22. SEC Release, *supra* note 3, at 58.

23. Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 849 (2017).

24. Jay Clayton, SEC Chairman, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018), <https://www.sec.gov/news/speech/speech-clayton-012218> [<https://perma.cc/UT6J-DE4Q>].

2013.²⁵ They found that through 2004, less than 1% of the S&P 1500 had implemented a clawback policy, but that in 2013 the fraction had grown to 62%.²⁶

The terms of these employer-initiated clawbacks are heterogeneous. BBBCS found that firms often report multiple, independent clawback triggers but that the most popular triggers are earnings restatements (included as a trigger by 77% of firms with a clawback), misconduct (52%), fraud (31%), and violation of a non-compete agreement (27%).²⁷ Of the clawback provisions that addressed coverage, 56% of firms extended clawbacks to executives beyond the “top 5.”²⁸ Sixty-nine percent of firms limit clawback obligations to executives directly responsible for a triggering event, while 31% extend clawback obligations to executives who are not directly responsible.²⁹ There is also heterogeneity with respect to the amount of compensation covered by the clawback. Most commonly, the full amount of a cash bonus or equity-based award may be recouped if a clawback provision is triggered, but a substantial minority of firms (ranging from 39% to 45%, depending on the type of compensation) limit clawbacks to the gains associated with the restated financials, fraud, misconduct, etc.³⁰ Employer-initiated clawback policies generally are overseen by a firm’s compensation committee or the entire board of directors, and in a majority of cases the overseer has the discretion to determine whether a triggering event has occurred and the amounts to be recouped, if any.³¹

Apparently, companies have only occasionally enforced voluntarily adopted clawback policies. BBBCS identified 272 instances in which a company restated earnings after adopting a clawback

25. BBBCS, *supra* note 4, at 42. The S&P 1500 data was compiled by Incentive Lab, now an arm of Institutional Shareholder Services. BBBCS also analyzed data from a larger sample of companies included in the Compustat database and found a similar increase over a broader time frame. *Id.*

26. *Id.* at 42 fig.2. As noted above, a recent report indicates that over 90% of the 100 largest firms have disclosed the adoption of some form of clawback policy. Agen, *supra* note 5.

27. BBBCS, *supra* note 4, at 45 tbl.2 panel B. Clawbacks predicated on violation of non-compete, non-solicitation, non-disclosure or similar contractual obligations are known in the industry as “bad boy” clawbacks.

28. *Id.* at 46 tbl.2 panel C.

29. *Id.* at 46 tbl.2 panel D.

30. *Id.* at 46 tbl.2 panel E.

31. *Id.* at 47 tbl.2 panels G, H.

provision and only 5 instances in which the board disclosed that the company sought to recoup compensation.³² They identified 3 other instances more recently.³³ They also note, however, that in some cases compensation may be “voluntarily” returned, avoiding the need to formally trigger a clawback policy.³⁴

C. Clawback Rationales

Clawback provisions might be mandated legislatively or adopted by firms voluntarily for a number of reasons. These reasons fall into two or perhaps three broad categories—an attempt to influence executive behavior *ex ante*, the prevention of unjust enrichment *ex post*, and compliance with investor wishes/best practices. And, of course, these rationales need not be mutually exclusive. We can learn something about the reasons for clawback adoption from legislative histories or discussions in proxy statements, but arguably the most persuasive evidence of purpose is provided by the design of a particular clawback provision.

1. SOX

Under SOX § 302, public company CEOs and CFOs are required to certify the accuracy and completeness of their annual and quarterly financial reports and the adequacy of internal controls. The clawback provision under SOX § 304 backs up the certification requirement by placing CEO and CFO compensation at risk. Promulgated in the wake of massive frauds at Enron, Worldcom, and other issuers, these provisions clearly were intended to reduce such fraud by reducing the incentive of these senior executives to misstate their financials in order to increase incentive compensation payouts.³⁵ The design of the SOX

32. *Id.* at 29.

33. *Id.*

34. *Id.* at 30. Anecdotal evidence suggests that clawback policies are becoming more aggressive, evolving, for example, from “double trigger” policies that required a restatement and unethical conduct to policies that follow the Dodd-Frank blueprint and are triggered solely by financial restatements. *See Trigger Happy: Will Clawback Offenses Grow?*, KORN FERRY, <https://www.kornferry.com/insights/articles/ceo-compensation-clawback> [<https://perma.cc/U5FR-28WU>] (last visited May 31, 2021).

35. The report of the House Committee on Financial Services made it clear that its intent was to limit disgorgement to cases in which

clawback reinforces the view that behavioral modification was a significant goal. The mandate extends only to restatements arising from misconduct. Clawback exposure is limited to the CEO and CFO—the two executives with the most influence over a firm’s financial reporting quality. And SOX clawbacks are not limited to excess compensation associated with a restatement. The entirety of incentive pay received within a specified window is at risk as well as profits from share sales during this period. When invoked by the SEC, the SOX clawback is a sledgehammer.

To be sure, even the SOX clawback design suggests some attention to ex post unjust enrichment. A CEO or CFO can be forced to disgorge incentive pay or trading profits even if he or she was completely unaware of the financial reporting misconduct of a subordinate. This feature appears to reflect President George W. Bush’s 2002 recommendation that “CEOs or other officers should not be allowed to profit from erroneous financial statements.”³⁶ But, of course, as CEOs and CFOs ultimately are responsible for the quality of their firms’ financial reporting, explicitly so after the enactment of SOX § 302, enforcing a clawback against them in cases of misconduct within their firms without evidence of personal misconduct is also consistent with a desire to maximize the pressure on these individuals to ensure compliance throughout the ranks, an ex ante deterrence rationale.

2. Dodd-Frank

The structure of the Dodd-Frank clawback provision and the Dodd-Frank’s legislative history suggest an increased emphasis on ex post unjust enrichment relative to ex ante behavioral modification, at least as compared to the SOX clawback. In its analysis of Dodd-Frank § 954,

“extreme misconduct” by an executive was provable. But the Senate version of the bill was enacted, and the report of the Senate Banking Committee was ambiguous with respect to scienter. *See* Kelsh, *supra* note 6, at 1017–19. Either way, it seems clear that the underlying rationale for § 304 was to combat accounting fraud.

36. *Fact Sheet: Corporate Fraud Conference Sponsored by President’s Corporate Fraud Task Force*, GEORGE W. BUSH WHITE HOUSE (Sept. 26, 2002), <https://georgewbush-whitehouse.archives.gov/news/releases/2002/09/20020926-2.html> [<https://perma.cc/E2FA-QPBD>] (detailing the President’s “Ten-Point Plan to Improve Corporate Responsibility and Protect America’s Shareholders,” announced on March 7, 2002).

the Senate Banking Committee explained that clawback provision “requires public companies . . . to recover money that they erroneously paid in incentive compensation to executives as a result of material noncompliance with accounting rules. *This is money that the executive would not have received if the accounting was done properly and was not entitled to.*”³⁷ The committee further expressed its belief that “it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously.”³⁸ The Committee report says nothing about deterring misreporting or other aberrant behavior.

To be sure, the Senate Banking Committee report on Dodd-Frank § 954 consists of only two paragraphs. Behavioral modification might have been an unspoken rationale for adoption, but the structure of § 954 also is consistent with the stated rationale of avoiding unjust enrichment and unfairness. Recall that the Dodd-Frank clawback is a strict liability, no-fault provision. It applies to a sizeable group of executives, not just executives with control or influence over financial reporting. And most importantly, under Dodd-Frank, it is only the unearned portion of compensation that is clawed back.

A number of commentators have criticized the Dodd-Frank clawback provision as being poorly designed to address incentives to misstate financial results. Professor Bainbridge labeled Dodd-Frank “[q]uack [f]ederal [c]orporate [g]overnance [r]ound II,”³⁹ and argued that the Dodd-Frank clawback provision was over-inclusive since it “encompasses all executive officers, without regard to their responsibility or lack thereof for the financial statement in question.”⁴⁰ Similarly, Professor Fried has argued that the “SEC’s proposed Dodd-Frank clawback reaches too many executives,” since clawing back compensation from executives below the “top 5” “cannot be expected to reduce [financial] misreporting.”⁴¹ And Professors Bank and Georgiev have argued that the Dodd-Frank clawback is overbroad in reaching a “large

37. S. REP. NO. 111-176, at 135 (2010) (emphasis added).

38. *Id.* at 136.

39. Bainbridge, *supra* note 6, 1779–80 (echoing Professor Roberto Romano’s reference to SOX as “quack corporate governance” in Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005)).

40. Bainbridge, *supra* note 6, at 1806.

41. Fried, *supra* note 6, at 6.

class of executives” and applying “irrespective of whether fraud occurred or who was at fault.”⁴²

But these appear to be more criticisms of Congress’s apparent objective in enacting the Dodd-Frank clawback than of the clawback design per se. The reach of the Dodd-Frank clawback is reasonable if the goal is to prevent unjust enrichment of executives arising from the confluence of incentive pay and accounting restatements. And this is an objective that the SEC took seriously. The SEC cites the Banking Committee’s statement of purpose numerous times in its proposed rulemaking. For example, in justifying mandated pro rata recovery among executives participating in “pool plans,” the SEC stated its belief “that permitting [board of director] discretion in these instances would be inconsistent with Section 10D’s no-fault standard and its goal of preventing executive officers from retaining compensation to which they are not entitled under the restated financial reporting measure.”⁴³

Given an objective of avoiding unfairness and unjust enrichment, the SEC’s proposal to interpret “executive officer” under Dodd-Frank § 954 consistently with the definition of “executive officer” under SEA § 16 (that is to say broadly, rather than narrowly limiting the population to “top 5” executives) seems perfectly reasonable.⁴⁴ Such

42. Bank & Georgiev, *supra* note 6, at 24.

43. SEC Release, *supra* note 3, at 74.

44. Securities Exchange Act of 1934 § 16(a) requires “a director or an officer” to register with the SEC and to report all trades in equity securities of their issuer. 15 U.S.C. § 78p(a). These individuals are also subject to the “short-swing” trading rule under § 16(b) that allows for disgorgement on a no-fault basis of profits derived by these individuals on trades of company securities within a six-month window. Section 16 does not define “director or an officer,” but the term has been interpreted by the SEC, in part, as follows:

The term ‘officer’ shall mean an issuer’s president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.

a definition is underinclusive, if anything, as it fails to require recoupment from non-executive employees who have received inflated compensation as a result of financial misreporting, but Congress limited the reach of § 954 to “executive officers,” not all employees, and the SEC must live within that constraint.

Given increasing concerns in recent years about growing wealth inequality, and particularly growing inequality between the super wealthy and the merely well off, Congress’s focus on unjust enrichment and unfairness in promulgating a mandatory clawback of unearned executive pay in Dodd-Frank seems highly prescient. Legislators seeking to avoid unjust enrichment of corporate executives might also have been motivated by underlying concerns with improving investor confidence in U.S. public companies and the security markets more generally. And these would all be plausible goals underlying a mandatory, no-fault clawback provision since individual companies would be unlikely to take into account broad public concerns such as these in deciding whether or how to enforce discretionary clawback policies.⁴⁵

3. *Employer-Initiated Clawbacks*

Not surprisingly, the rationales firms provide for adopting clawbacks differ somewhat from the rationales of legislators.⁴⁶ BBBCS report data on reasons stated in proxy statements for clawback adoption. Some are chiefly administrative—the clawback was adopted as part of a larger compensation plan (25% of firms) or as part of an employment agreement (13%)—but other reasons provided were more substantive—to mitigate excessive risk taking (13% of firms).⁴⁷ Ten percent of firms cited SOX as a reason for adopting a clawback provision, although

45. While endorsing no-fault clawbacks, Professors Murphy and Jensen have argued that boards of directors should have more discretion than that provided by the Dodd-Frank provision to determine whether to pursue clawbacks. Murphy & Jensen, *supra* note 6, at 41 (noting the difficulty of pursuing clawbacks from employees who have paid taxes on compensation). But in my view, Murphy and Jensen underestimate how reticent boards will be to pursue clawbacks absent a mandate. See BBBCS, *supra* note 4 (providing evidence that boards rarely enforce voluntarily adopted clawback policies).

46. As suggested above, we would not expect companies to focus on systemic issues, such as improving investor confidence in the securities markets generally, in deciding whether to voluntarily adopt a clawback policy.

47. BBBCS, *supra* note 4, at 45 tbl.2 panel A.

SOX does not require firms to do so, and another 10% cited Dodd-Frank, suggesting that these firms were getting ahead of the curve.⁴⁸ A number of firms cited improved corporate governance (9%), improved executive/shareholder alignment (4%), or best practices (2%) as rationales for adoption.⁴⁹

Although not explicitly provided as a rationale, a number of firm-initiated clawbacks are intended at least in part to enforce contractual agreements. Twenty-seven percent of firms that detailed clawback triggers listed violation of a non-compete as a trigger.⁵⁰ Another 16% listed violation of a non-solicitation agreement and 16% listed violation of a non-disclosure agreement as clawback triggers.⁵¹ The adoption of these “bad-boy” triggers suggests that preventing these behaviors is a goal of many voluntarily adopted clawback policies.

According to BBBCS’s evidence, firms do not expressly state that they are adopting clawbacks in an effort to minimize the rewards to and amount of financial misreporting or to avoid the unjust enrichment of their executives, but their stated rationales are not inconsistent with these justifications either. It is intriguing that 13% of firms report mitigating excessive risk taking as a rationale. This could be an oblique reference to “aggressive” financial reporting or could refer to aggressive business positions or both. This point is explored further in the following Part. In sum, however, the evidence, such as it is, supports a range of predictable rationales for mandating or voluntarily adopting clawbacks, including mitigation of financial misreporting or excessive risk taking, penalizing contractual breaches, and prevention of unjust enrichment.

III. OPTIMAL CLAWBACK TAXATION

As we will see momentarily, employee income taxes can consume up to 50% of executive compensation. As a result, the tax treatment of clawed back compensation takes on real importance. This Part will focus on the optimal tax treatment of clawbacks from several perspectives and will argue that the optimal regime would be one in which any taxes paid on compensation prior to its being clawed back would be fully refunded.

48. *Id.*

49. *Id.*

50. *Id.* at 45 tbl.2 panel B.

51. *Id.*

A. Overview of Compensation Taxation: What's at Stake?

The tax consequences of clawbacks can be significant, but they vary depending on the type and timing of compensation subject to a clawback obligation. This Subpart provides a general overview of compensation taxation as a prelude to consideration of an optimal clawback tax regime.

Consider this paradigm case. An executive receives a \$1 million cash bonus in 2019. The bonus is ordinary income that we will assume is taxed at the current maximum federal rate of 37%.⁵² If the executive works in a high tax state like New York or California, she will pay state income tax at rates approaching 10% or more.⁵³ Medicare tax adds another 2.35% for high-income employees.⁵⁴ In total, because the compensation is ordinary income, the employee tax burden can approach or even exceed 50% of the bonus payment.⁵⁵ Unless the deduction is barred by I.R.C. § 162(m),⁵⁶ the employer should be entitled to deduct

52. Pub. L. No. 115-97, 131 Stat. 2054, § 11001 (2017) [hereinafter TCJA]. This act is colloquially known as the Tax Cuts and Jobs Act.

53. The maximum marginal tax rate on personal income in New York is 8.82%. *Tax Year 2019 New York Income Tax Brackets*, TAX-BRACKETS.ORG, <https://www.tax-brackets.org/newyorktaxtable> [<https://perma.cc/AU26-6K45>] (last visited May 31, 2021). The maximum marginal rate in California is 13.3%. *Tax Year 2019 California Income Tax Brackets*, TAX-BRACKETS.ORG, <https://www.tax-brackets.org/californiataxtable> [<https://perma.cc/S8CF-6ZVN>] (last visited May 31, 2021).

54. Employees pay a 1.45% Medicare tax on all compensation. High-income employees pay an additional 0.9%. SOC. SEC. ADMIN. PUB. NO. 05-10024, UNDERSTANDING THE BENEFITS 3 (2021), <https://www.ssa.gov/pubs/EN-05-10024.pdf> [<https://perma.cc/E4RW-UJYU>]. Employers also pay 1.45% Medicare tax on all wages, *id.*, and it is generally understood that the incidence of the employer-paid Medicare tax falls on employees. This may or may not be true for executive bonuses, but the taxes executives bear on bonuses are very large either way.

55. Under the TCJA, state taxes are only deductible up to \$10,000. TCJA, *supra* note 52, § 11042. For a high-income executive, the state tax on a bonus would be non-deductible in practice, and thus the federal, state, and Medicare rates can be added to generate a combined effective rate.

56. Prior to the enactment of the TCJA, compensation of a public company's "top five" executives beyond \$1 million per executive per year was not deductible unless it was performance based, but the cash and equity-based bonuses at issue here could easily have been structured to ensure full

the \$1 million payment, but the point is that the tax dollars at stake are very significant.

If we substitute a bonus paid in stock worth \$1 million, the tax result is exactly the same. The timing of taxation of equity pay is more complex, but when a stock grant vests or an option is exercised, the gains generally are taxed to the recipient as ordinary income,⁵⁷ and the employer is entitled to an equivalent deduction.⁵⁸

Now suppose that the executive is required to return the cash bonus or equity compensation in 2020. If the employer was able to deduct the bonus when paid, it will generally be required to include the amount recouped in income and will pay tax on that amount. The employer, in other words, will generally face no net tax consequences from having paid and recouped a bonus. But will the executive be able to deduct the repayment or receive a credit for tax paid in 2019? If not, the executive could face a net cost of \$500,000 for the privilege of holding \$1 million in cash or stock worth \$1 million for a year. This critical question is the subject of Part IV.⁵⁹

deductibility. *See* I.R.C. § 162(m)(4) (2016). Today, given the TCJA, public company top five executive pay in excess of \$1 million per year is not deductible, full stop. TCJA, *supra* note 52, § 13601(a).

57. There are exceptions. Recipients of restricted stock may make an election under I.R.C. § 83(b) to include the value of the stock in income at grant rather than at vesting, but, because the tax paid at grant cannot be recovered if the stock fails to vest, § 83(b) elections by employees of companies with publicly traded stock are rare. *See* David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 707 (2004) (citing interview evidence). Gains arising from Incentive Stock Options (ISOs) are taxed when a recipient sells the underlying shares rather than upon option exercise (*see* I.R.C. § 421(a)), but limitations on the grant of ISOs result in these options being economically insignificant relative to “nonqualified” stock options. *See, e.g.*, Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL’Y & ECON. 1, 7 (2000) (reporting that ISOs account for about 5% of compensatory options).

58. Again, unless the deduction is barred by I.R.C. § 162(m).

59. Another possibility, considered in Part VI below, is that the company reduces the executive’s 2020 compensation by \$1 million in lieu of requiring the executive to return the 2019 \$1 million bonus. But it is likely that this technique would have the same tax consequences as explicit repayment.

In some instances, however, compensation subject to a clawback may not have been taxed in the first instance, eliminating any tax issue upon recoupment. Suppose, for example, that the executive received her \$1 million bonus in February 2019 and that the bonus was returned in October 2019 as a result of an intervening accounting restatement. Assuming that the executive employs the calendar year as her fiscal year, this pair of transactions would have no income tax consequences as both occurred during the same tax year.⁶⁰ The combination of transactions would yield a “tax nothing.”

Alternatively, suppose that the executive made an election in 2018 to defer any cash bonus received in 2019 until retirement under her firm’s nonqualified deferred compensation plan. In this case, the executive would not pay income tax on the bonus when earned in 2019, and her employer would not be entitled to a deduction in that year.⁶¹ The deferred bonus would normally be taxed to the executive and deducted in the year of payment, but if clawed back in 2020 (or at any point before payment), there would be no tax consequences arising from the transactions; again a tax nothing.⁶²

There are other situations in which incentive compensation would not have been taxed prior to being clawed back in a future year. Suppose a firm awards performance shares to their executives under the following terms: The number of shares awarded will be determined based on the firm’s average earnings performance over the 2015–2018 period, but the shares awarded will not vest in the executives, i.e., become owned outright, until 2021.⁶³ The executive is awarded 10,000 shares in 2019 based on reported earnings for the three-year period. Because the shares are unvested, they are not included in income at that time. In 2020, the firm restates earnings for 2017–2018. Given the downward revision, the executive should have received 8,000 shares.

60. Penn v. Robertson, 115 F.2d 167, 175 (4th Cir. 1940) (“rescission” of money received “before the close of the calendar year[] extinguished what otherwise would have been taxable income”).

61. Robert A. Miller, *Nonqualified Deferred Compensation Plans*, in EXECUTIVE COMPENSATION 211, 268–69 (Yale D. Tauber & Donald R. Levy eds., 2002).

62. A clawback of deferred compensation may present problems under I.R.C. § 409A. See *infra* Part VI.

63. Alternatively, the shares may be designed to vest in 2018 with payout deferred until 2021. In order to defer income tax application until 2021, such a deferral would have to comport with the rules of § 409A.

Two thousand shares are recouped. There is no need or basis for a tax deduction or credit. From a tax perspective, this is equivalent to the executive having received 8,000 unvested shares to begin with.⁶⁴

These last two examples are important because they highlight potential inequities and dynamic effects arising from the tax rules applicable to clawbacks. Most large public companies have elective deferred compensation programs.⁶⁵ If it turns out that the receipt and repayment of a *non-deferred* cash bonus results in adverse net consequences for an executive, two similarly situated executives could face very different clawback tax consequences depending on whether they elect to defer bonuses. Similarly, many companies make performance awards comparable to that outlined in the paragraph above but deliver vested (and taxed) shares at the end of the three-year performance period. In this situation, the tax treatment of clawed back shares would be important, and that tax treatment might influence the design of performance awards.

Now that we have a sense of what's at stake, we can consider the optimal tax treatment of clawed back compensation and then evaluate the current tax rules against that benchmark. But before we do, it will be helpful to briefly consider who bears the cost of clawbacks and the taxes on clawed back compensation.

64. This is essentially the SEC's example in its proposed rulemaking. See SEC Release, *supra* note 3, at 54–55.

65. Approximately three quarters of large companies offer non-qualified deferred compensation programs currently. See Doug Frederick et al., *Executive Benefits Within the Responsible Executive Compensation Framework*, MERCER 2 (2016), <https://www.mercer.com/content/dam/mercer/attachments/global/Talent/executive-reward-perspectives/2016/gl-2016-executive-benefits-within-the-responsible-executive-compensation-framework-mercer.pdf> [<https://perma.cc/N6NN-RZ6V>] (reporting that 72% of Fortune 500 companies offered nonqualified savings plans in 2016); Newport Grp., *Executive Benefits: A Survey of Current Trends* 13 (2014/2015 ed.) (noting that 72% of Fortune 1000 companies offered a nonqualified savings plan in 2013); see also Rebecca Moore, *Employers Want to Boost NQDC Plan Participation*, PLAN ADVISOR (Aug. 14, 2014), <https://www.planadviser.com/employers-want-to-boost-nqdc-plan-participation/> [<https://perma.cc/36B2-9GPL>] (describing Newport Group survey).

B. Clawback and Clawback Tax Incidence

Who bears the cost of clawed back compensation and of any net tax obligation resulting from the receipt and repayment of clawed back compensation? Executives bear these costs in the first instance, but, as a class, executives are unlikely to ultimately bear 100% of these costs. Under any conception of the executive pay-setting process, one would expect executives subjected to clawbacks to demand and receive compensation for the increased riskiness of their pay.⁶⁶ And, indeed, empirical evidence indicates that clawback adoption leads to increased compensation for executives.⁶⁷ Moreover, presumably, executives would demand to be compensated for incurring net tax obligations on compensation they are forced to disgorge, shifting at least part of the tax burden onto shareholders.

Thus, companies and their shareholders should expect to bear a significant portion of these costs.⁶⁸ And so, the tax treatment of

66. The two leading, non-mutually exclusive, theories of the executive pay-setting process are the optimal contracting theory and the rent extraction theory. The optimal contracting view posits that executive pay arrangements are selected to minimize managerial agency costs and maximize shareholder value. See John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL'Y REV., Apr. 2003, at 27, 27–28. The managerial power view posits that executive pay arrangements reflect agency costs, as well as combat them, and that compensation design is not consistent with shareholder value maximization. Under this view, the threat or reality of investor and financial press outrage plays an important role in disciplining compensation, and, as a result, executives and directors seek out low salience channels of pay and other means of camouflaging compensation to minimize outrage. See Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 789 (2002).

67. See Ilona Babenko et al., *Internet Appendix to Accompany "Clawback Provisions and Firm Risk"* 1–2 (Apr. 30, 2019) (on file with author) [hereinafter BBBCS, *Internet Appendix*] (finding that clawback adoption at S&P 1500 companies leads to an average increase in aggregate top 5 executive pay of more than \$300,000 per year).

68. These costs may well be justified if they reduce overall agency costs, just as the cost of the external audit function may be justified.

clawback payments isn't just a concern for executives; it's a concern for investors generally.⁶⁹

This is not to suggest, however, that the cost of clawed back compensation or a net tax liability following a particular clawback event would be passed on to shareholders dollar for dollar. The idea here is that executives are likely to be compensated on an expected cost basis for the risk of a clawback being imposed, but once a clawback is imposed, the costs likely remain with the executives. Of course, it is possible that a sympathetic board or compensation committee might boost executive pay following a particular clawback event, but if the clawback is significant it would be difficult to make the executives whole for clawed back compensation without incurring the wrath of investors.⁷⁰

It is somewhat more plausible that companies would reimburse or "gross up" executives for net tax liabilities resulting from particular clawback events. Although tax gross ups are extremely expensive and strongly discouraged today by proxy advisory firms and other investor advocates, companies historically have made executives whole for taxes imposed with respect to various transactions and perks.⁷¹ This possibility is further explored in the next Subpart. But to the extent that executives are compensated ex ante for net tax costs and not grossed up

69. Labor may bear part of the burden as well. See David I. Walker, *Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?*, 57 VILL. L. REV. 653, 654 (2012) (arguing that like corporate income taxes, managerial agency costs are likely borne in part by suppliers of capital and in part by labor).

70. Suppose, for example, that an executive estimates that there is a 1 in 20 chance, per year, of a clawback-triggering event that would result in her being required to return \$2 million in comp. The executive might seek \$100,000 per year additional compensation to offset this risk. Assume that the board boosts her pay by this amount. Now suppose that a triggering event does occur in 2020 and the executive returns \$2 million. Presumably, she would bear much or all of this cost as shareholders have already paid for this ex ante and because a \$2 million added bonus to cover the clawback would be difficult to hide or justify.

71. See *infra* Part III.C.3. Tax gross ups are expensive because the payments to cover tax obligations are also taxable income, requiring further taxable payments. At a 50% combined state and federal income tax rate, a company would need to pay an executive \$1 million to fully reimburse her for a \$500,000 tax obligation. *Infra* Part III.C.3.

ex post, any adverse tax treatment of clawed back compensation not only imposes costs on shareholders, it also may result in differential treatment of similarly situated executives, as discussed above, and, as discussed below, in excessive reduction of risk and/or distortions to clawback program design and implementation of executive pay practices more generally.

C. The Optimal Tax Treatment of Clawed Back Compensation

This Subpart considers the optimal tax treatment of repaid compensation in light of the various rationales for clawback mandates or their voluntary adoption. It takes into account the fact that clawbacks and the tax treatment of clawback payments have dynamic effects, that company boards have discretion in the adoption and implementation of clawbacks and in compensation design, and that tax rules applicable to clawbacks will impact the use of that discretion. It assumes in the first instance that executives bear the net tax costs of particular clawback events but also reconsiders the picture if taxes are grossed up. Ultimately, I conclude that compensation that is paid and subsequently clawed back ideally should result in zero net tax consequence for executives and employers.

1. Clawback Rationales and Tax

As discussed above, clawback provisions might be mandated or voluntarily adopted in an effort to deter financial misreporting or excessive risk taking, to encourage compliance with non-compete and other agreements, or to prevent unjust enrichment. Given that up to 50% of executive bonuses can be consumed by taxes, the tax treatment of clawback payments can play an important role in facilitating or undermining the achievement of these goals. In theory, that tax treatment could range from complete offset of any taxes paid on the recouped compensation, to no offset, or to something in between.

a. Prevention of Unjust Enrichment

Let us begin where the answer is clearest: no-fault clawbacks of excess compensation intended to prevent unjust enrichment of executives. I've argued that the legislative history and the structural details of the Dodd-Frank clawback are consistent with an unjust enrichment

rationale.⁷² Under this conception, executives should receive and retain exactly what they were promised, no more and no less, but the determination of what is owed to an executive should be based on full and correct information, including any restated financial data. Tax treatment of clawback payments that perfectly offsets the taxation of any prior inclusion is, I believe, most consistent with an objective of avoiding unjust enrichment.

In its proposed rulemaking under Dodd-Frank, the SEC went to some length to define and describe how clawback policies should be designed in order to ensure repayment of “the amount of incentive-based compensation received [by the executive officer or former executive officer] that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement.”⁷³ This is no small task, particularly for incentive compensation that is awarded based on a firm’s artificially inflated share price that exists prior to a restatement.⁷⁴ It would be much easier to simply require recoupment of all incentive pay received within some window of a restatement, à la the SOX clawback. The fact that the Dodd-Frank clawback and many firm-initiated clawback policies are predicated on recoupment of excess compensation, rather than all incentive compensation associated with a triggering event, suggests a focus less on punishment than on getting to the right level of compensation.

The SEC’s proposed rule also specifies that the determination of excess compensation is to be made pre-tax, that is, “computed

72. *Supra* Part II.C.2.

73. SEC Proposed Rule § 10D–1(b)(1)(iii), SEC Release, *supra* note 3, at 180.

74. Fried argues that these are “guesstimate[s],” but this characterization seems extreme. Fried, *supra* note 6, at 52–54. Presumably, event studies generally can be used to estimate the impact of faulty financials on share price. Event studies are inexact but are widely used in securities litigation. See generally Jill E. Fisch et al., *The Logic and Limits of Event Studies in Securities Fraud Litigation*, 96 TEX. L. REV. 553 (2018). In its proposed rulemaking, the SEC discussed the potential use of event studies to determine excess compensation arising from restatements and also highlighted the difficulties. The SEC will not mandate the use of event studies but plans to “permit an issuer to use any reasonable estimate of the effect of the restatement on stock price and TSR.” SEC Release, *supra* note 3, at 127.

without regard to any taxes paid,”⁷⁵ in order to ensure full recovery by the employer and to reduce the administrative burden of determining after-tax amounts received by various executives. This makes sense. Recovery of excess compensation on a pre-tax basis makes the shareholders whole.⁷⁶ Assuming no significant change in tax rates, a company’s earlier deduction for compensation paid, if any, will be offset by the inclusion of compensation recouped. So, a company applying the SEC’s proposed rule generally would be made whole, ex post, both before and after tax.⁷⁷

Pre-tax recovery of excess compensation also ensures that the executives subject to the clawback are not unjustly enriched pre-tax. However, unless repayment results in an exact offset of any taxes paid as a result of the earlier inclusion, the executives may be unjustly enriched after tax (if repayment reduces an executive’s taxes more than the prior inclusion increased them) or, more likely, penalized after-tax (if repayment reduces taxes less than the prior inclusion increased them).⁷⁸

*b. Reducing Financial Misreporting and
“Bad Boy” Behaviors*

The SOX clawback seems designed to deter financial misreporting by reducing the expected profit associated with that activity. I’ve referred to this clawback as a sledgehammer given that it contemplates the recovery by an employer of all incentive pay, not just excess pay, associated with triggering restatements as well as recovery of share sale

75. SEC Proposed Rule § 10D-1(b)(1)(iii), SEC Release, *supra* note 3, at 180.

76. That is, recovery makes the shareholders whole on an ex post basis. Investors may pay for expected clawbacks ex ante through greater compensation.

77. If a deduction was allowed to the employer at the time of payment, the amount recovered will be included in income when recouped. If a deduction was not allowed per § 162(m), there will be no inclusion upon recoupment. I.R.C. § 111. Either way, shareholders will be kept whole, ex post, pre- and post-tax.

78. As discussed *supra* Part III.B, I assume in Parts III.C.1 & 2 that investors bear part of the cost of clawbacks and any adverse tax treatment of clawbacks on an ex ante basis, but that executives bear the cost of particular clawback events. Another possibility, discussed in Part III.C.3, is that companies gross up executives for the adverse tax consequences of clawbacks.

profits, not just “excess” profits.⁷⁹ Congress apparently wasn’t worried about over-deterrence when it adopted this clawback approach.

Assuming that there is no real risk of over-deterrence, a clawback tax regime providing for full tax offsets, no tax offsets, or anything in between would be consistent with deterrence of financial misreporting. But is it really appropriate to ignore over-deterrence? In this case, it probably is. To the extent that the SOX clawback is only invoked in cases of purposeful financial misreporting, the risk of over-deterrence should be small. The ideal amount of purposeful financial misreporting is zero. Similarly, to the extent that companies have adopted “bad boy” clawback provisions to deter executives from violating non-competition, non-solicitation, or non-disclosure agreements, and companies are not concerned about over-deterrence, these objectives also are supported by any tax treatment of paid and recouped compensation that is on net neutral or worse than neutral.

c. Mitigating Excess Risk-Taking Incentives

The evidence collected by BBBCS suggests that employer-initiated clawback policies differ substantially from those specified by SOX and Dodd-Frank.⁸⁰ They find that voluntary clawback adoption is associated with a reduction in risk taking and that the reduction does not relate purely to financial risk but also to investment risk.⁸¹ As they note, clawbacks can mitigate imprudent risk taking but can also reduce prudent risk taking. They find, however, that stock market reaction to clawback adoption is generally positive, suggesting that the market believes, on average, that the reductions in risk taking induced by clawback adoption are value increasing.⁸²

To the extent that risk management is an objective of clawback adoption, the tax treatment of recoupments again becomes important, particularly in a world in which income taxes can consume 50% of incentive pay. There is a real concern that prudent risk taking could be

79. *Supra* Part II.C.1.

80. *Supra* Part II.C.3.

81. BBBCS, *supra* note 4, at 2.

82. BBBCS theorize that clawback adoption can be value enhancing as it may solve a horizon problem that relates to the timing mismatch between current managerial action and future observable consequences. *Id.* at 9.

inefficiently inhibited if the expected after-tax financial penalty associated with a clawback triggering event is too high. Moreover, because incentive pay may or may not have been taxed prior to a clawback, balancing these incentives would be quite difficult under a tax regime that did not allow for full recovery of taxes paid on compensation received that is subsequently recouped. Doing so is much more straightforward with full tax offsets.

Consider the following example. A company's board of directors is concerned about risk taking and attempts to balance incentive pay, which creates risk taking incentives, with clawback policies, that mitigate excessive risk taking by permitting ex post review of decision making. The compensation committee determines that the following scheme best aligns its VP's risk-taking incentives with shareholder interests: a bonus of \$0 to \$5 million (after-tax) based on three-year total shareholder return relative to a peer group of firms with a no-fault clawback of any unearned compensation. The company also has an elective deferred compensation program in which Valerie VP participates, but Victor VP does not. At a 50% tax rate, the committee can accomplish its intended result with respect to both Valerie and Victor by providing a \$0 to \$10 million pre-tax bonus, if, but only if, full tax offsets are provided for any clawed back compensation. Suppose, for example, that faulty financials result in payment of the maximum \$10 million bonus in 2019 but that restated financials produced in 2020 support only an \$8 million bonus. Valerie deferred her bonus and has not yet paid tax. She returns \$2 million to company and is left with \$8 million pre-tax, and ultimately \$4 million after tax is paid on the bonus at the end of the deferral period. Victor paid \$5 million tax on receipt of his bonus. With full tax offsets, Victor would receive a \$1 million tax refund when he returns \$2 million to Company, also leaving him with \$4 million after tax. If no tax offsets are allowed for recouped compensation, however, Valerie would still net \$4 million, but Victor would net only \$3 million.

To be sure, I am somewhat skeptical that firms manage risk-taking incentives in precisely this fashion, but the upshot is the same: full offset of previously paid taxes is most consistent with facilitating a risk management clawback objective.

2. Fairness, Dynamics Responses, and Other Considerations

While allowing full offset of employee tax previously paid on clawed back compensation is consistent with the various rationales for clawback imposition or voluntary adoption, it is most strongly dictated by

an objective of avoiding unjust enrichment of, but not penalizing, executives who receive excess pay as a result of misreported financials. Once other considerations are taken into account, however, the normative case for full offsets becomes even stronger.

a. Fairness

Fairness in taxation is a big, contested issue.⁸³ Here, I will focus solely on two (still controversial) principles, horizontal equity and avoiding punishment of innocents.

Horizontal equity requires equal taxation of similarly situated taxpayers.⁸⁴ This too is a contested concept,⁸⁵ but I have in mind only the desirability of applying consistent taxation to individuals engaged in economically indistinguishable transactions, an intuitive horizontal equity, if you will.⁸⁶ Unless “similarly situated” is defined very narrowly, equal taxation of similarly situated executives subject to a clawback can only be assured under a tax regime that provides for full offset of previously incurred tax on recouped compensation. Again, the easiest way to see this is to compare the situation of our two executives who are forced to repay compensation—Valerie and Victor—and who are identical in every way except that Valerie has elected to defer her bonus (and the tax on that bonus) until retirement while Victor has not made that election and has paid tax currently. In a full tax offset regime, Valerie’s repayment will have no tax consequence, since her bonus was not previously taxed, while Victor will receive a deduction or credit offsetting his prior tax obligation on the recouped amount. On net, they

83. See Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323, 1324 (2008) (noting that “[t]he concept of tax fairness is presently in some disrepute” in academic tax circles). There is agreement that as a society we “should care about distributive justice” but not much agreement beyond that. *Id.*

84. *Id.* at 1325 & n.3 (citing R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45 (1967)).

85. Galle, *supra* note 83, at 1324–25 (discussing critiques of the horizontal equity principle pressed by Louis Kaplow, Liam Murphy and Thomas Nagel, and others).

86. As Galle notes, *id.* at 1326 & n.8, despite the persuasive academic critiques of horizontal equity, the concept continues to exhibit an intuitive and lasting appeal (citing Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354, 358 (1993)).

will face the same tax on the same post-clawback income. Under a regime providing for no deduction or credit for previously incurred tax, Valerie would still face no net tax as a result of the bonus award and recoupment while Victor would incur a net tax obligation of up to 50% of the recouped bonus.⁸⁷

One can also think of fairness in this context as avoiding financial punishment via clawbacks of executives who played no part in activities leading to earnings restatements. Under an unjust enrichment perspective, these executives should not profit from the misreported results, but they should not be penalized either. Under this view, the case for full tax offsets seems particularly compelling in the context of no-fault clawbacks enforced against executives with no involvement in particular misreporting and no overall responsibility for a company's financial reporting—for example, a vice president of research and development at a firm that has misreported sales. Under the Dodd-Frank approach, only excess compensation is recovered from these executives, which intuitively seems fair. However, without full tax offsets, the executives could face a net tax obligation of up to 50% on compensation that was received and repaid, which seems intuitively unfair.⁸⁸

b. Adoption and Implementation of Clawback Regimes

In the absence of final rule making under Dodd-Frank, the adoption and implementation of clawback policies is largely at the discretion of company boards of directors. To be sure, the SEC has the power to pursue clawbacks against CEOs and CFOs under SOX, and the SEC

87. Here, again, I am assuming that executives bear whatever net tax flows from a particular clawback event. This may not be the case. See *infra* Part III.C.3.

88. The equities in this situation remind one of *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). There, the taxpayer incurred deductible expenses between 1913 and 1916 that exceeded gross income. Subsequently, the taxpayer collected a judgment related specifically to the prior expenses. The taxpayer argued that the earlier losses and subsequent recovery should be netted to determine taxable income. The Supreme Court held that such a result was inconsistent with annual tax accounting. Of course, Congress responded to the inherent unfairness of situations like that in *Sanford & Brooks* by providing for net operating loss deductions. See I.R.C. § 172. Providing full tax offsets for clawback payments would reflect a similar spirit.

has in recent years become more aggressive in doing so,⁸⁹ but even so, SOX clawbacks are largely confined to the most egregious cases. The proxy advisory services place some pressure on firms to voluntarily adopt clawbacks, but the compensation “scorecard” promulgated by Institutional Shareholder Services, the largest proxy advisory firm, asks only whether a company maintains a “sufficient” or “rigorous” clawback policy; it does not prescribe best practices for clawback design or implementation.⁹⁰ If we want firms to adopt comprehensive clawback policies and to implement them aggressively, or at least evenhandedly, the tax treatment of recouped compensation matters.

Imagine the worst-case clawback tax scenario, from the point of view of companies and their executives, in which compensation is taxed to the executives when received but is not deductible or creditable for the executives when recouped. Assuming, reasonably, that the tax treatment of an employer that recoups compensation will be neutral,⁹¹ this tax treatment of the executives would impose a joint employer/employee tax burden on recouped compensation, and that has several pernicious effects.⁹²

As discussed above, the net cost associated with such a tax regime is unlikely to be borne solely by the executives. Executives subjected to such a regime would demand greater compensation to offset the risk of incurring net tax obligations on compensation they cannot keep, shifting at least part of the tax burden onto shareholders. But however the net burden is borne in aggregate, a tax regime that fails to provide for full tax offsets for disgorged compensation will discourage the

89. See *supra* note 17 and accompanying text.

90. See *United States Proxy Voting Guidelines*, ISS GOVERNANCE 45, 51 (Nov. 19, 2020), <https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf> [<https://perma.cc/36B4-CMCH>] [hereinafter *ISS Guidelines*].

91. Recouped compensation will be included in the employer’s income only if and to the extent that the compensation was previously deducted by the employer and the deduction reduced the employer’s taxes. I.R.C. § 111.

92. As Myron Scholes and Mark Wolfson have repeatedly emphasized, the analyst must consider all taxes, all parties, and all costs in evaluating the tax consequences of various rules or transactions. See MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 183 (2d ed. 2002); Myron S. Scholes & Mark A. Wolfson, *Taxes and Employee Compensation Planning*, 64 *TAXES* 824 (1986).

voluntary adoption of clawback policies and discourage the adoption of more comprehensive, no-fault policies by adopting companies.⁹³

Moreover, to the extent that companies have discretion with respect to implementation within mandated clawback regimes or their own voluntarily adopted policies, boards or compensation committees are likely to use that discretion to minimize the scope of executive clawback obligations in the worst case, no tax offset scenario.

A tax regime that provides for full tax offsets for recouped compensation would not impose an additional, external cost onto clawback programs. To be sure, executives will still demand to be compensated for the risk of losing compensation due to a clawback, and, in particular, due to a no-fault clawback triggered by another executive's error or malfeasance, but taxes would not add to the possible losses under a full offset tax regime.

c. Impact on Compensation Design

We should also consider the impact of clawback policies, and the taxation of clawbacks, on executive compensation design, which is certainly subject to board of director/compensation committee discretion. The interactions are complex, but the bottom line is the same: full tax offsets will ensure that the tax treatment of clawbacks does not in itself distort compensation design.

Taxes aside, the existence of a clawback provision, whether mandated or voluntarily adopted, is likely to impact compensation design, and perhaps in unpredictable ways. Professors Roberta Romano, Sanjai Bhagat, and Stephen Bainbridge have argued that the imposition of clawbacks on incentive compensation likely results in firms shifting away from incentive compensation in favor of greater salaries.⁹⁴ BBBCS find, however, that firm-initiated clawback policies

93. Similarly, to the extent that executives have discretion as to whether to restate earnings, the imposition of a restatement-triggered clawback will tend to discourage restatement filings, and asymmetric tax treatment of clawbacks will further discourage such filings. *See* Fried, *supra* note 6, at 15 (discussing a case in which management's refusal to file a restatement precluded the application of a SOX clawback provision).

94. *See* Bainbridge, *supra* note 6, at 1807 (noting that companies reduced incentive compensation and increased executive salaries in response to the SOX clawback and implying that the response to the Dodd-Frank

are associated with *more* equity-based incentive pay and more pay overall.⁹⁵ One possible explanation for the former association is that equity pay awards increase the incentive for managers to manipulate financials in order to increase equity compensation payouts and that clawbacks offset that incentive to some extent by imposing an ex post correction when and if such manipulation is uncovered. Equity pay is more attractive from the shareholders' perspective if manipulation can be mitigated, and so clawback adoption is associated with more equity pay, or so this story goes.⁹⁶

Notably, the SEC's proposed clawback rules under Dodd-Frank reach some forms of incentive pay but not others. The SEC's Dodd-Frank clawback rules would include stock and options that vest based on satisfaction of a financial reporting goal but would not reach simple time-vested stock and options.⁹⁷ The trend in executive pay design over the last two decades has involved a shift away from the latter and towards the former,⁹⁸ but adoption of a mandatory, no-fault clawback rule that incorporates this distinction could potentially reverse this trend. In my view, this would mark an unfortunate return to less performance sensitive executive compensation.

Limited deductibility of clawback payments that increases the cost to executives (and indirectly to companies) of recouped pay could reinforce the shift in favor of increased performance-based pay observed by BBBCS, or it could encourage companies to shift away from compensation subject to clawbacks, particularly under a mandatory, no-fault Dodd-Frank clawback regime. It is impossible to predict, but what one

clawback could be similar); Bhagat & Romano, *supra* note 6, at 366 (reporting that SOX clawbacks led to a decrease in executive incentive compensation and an increase in salaries). Professors Fried and Shilon note that the evidence that Bainbridge, Bhagat, and Romano reference was based on the punitive SOX clawback and that excess pay clawbacks, such as the Dodd-Frank clawback, "should not distort pay arrangements." Fried & Shilon, *supra* note 6, at 747.

95. BBBCS, *Internet Appendix*, *supra* note 67, at 2–3.

96. *Id.* Another possibility noted by BBBCS is that to the extent that clawback adoption reduces executive risk taking, it may be in the shareholders' interest to increase equity pay to maintain risk-taking incentives. *Id.* at 3.

97. See SEC Release, *supra* note 3, at 47.

98. David I. Walker, *The Way We Pay Now: Understanding and Evaluating Performance-Based Executive Pay*, 1 J.L. FIN. & ACCT. 395, 405–08 (2016).

can say with confidence is that a clawback tax regime that allows for full offset of previously paid tax would not exacerbate any distortions in compensation design that result from the adoption of clawback rules *per se*.

Of course, a more direct response to limited deductibility of clawback payments would be to design compensation so that it is not taxed to recipients until after the potential clawback window has closed, thereby obviating any concern with the offset of previously paid taxes.⁹⁹ Recall the earlier example of shares awarded based on 2015–2018 performance that do not vest until 2021. These shares would not be taxed until 2021 and any restatement of 2015–2018 financials is more likely than not to have occurred prior to that date.¹⁰⁰ Alternatively, limited deductibility might encourage greater elective deferral of incentive compensation into nonqualified deferred compensation plans, reducing the amount of previously taxed compensation subject to being clawed back.¹⁰¹ Although these would be distortions induced by limited deductibility, they are not necessarily “bad” distortions. Increased vesting periods for incentive pay and increased deferred compensation both

99. Another possibility might be for the company to reduce executive pay in a subsequent year by the amount of the clawback in lieu of requiring an executive to repay the clawback amount. One might expect this approach to eliminate any adverse tax consequences associated with actual repayment, but this is unlikely to be true. *See infra* Part VI.B.

100. Studies of restatements reveal that most occur within a half-year of the end of the period of misreporting and that the median period of misreporting is between 1.75 and 2.75 years. *See* Mark Hirschey et al., *The Timeliness of Restatement Disclosures and Financial Reporting Credibility*, 42 J. BUS. FIN. & ACCT. 826, 841 (2015) (examining 348 restatements by U.S. companies between 1997 and 2006 and finding a 2.75 year median length of the restated period (3 years at the 75th percentile) and a 0.4 year median delay between the end of the misreported period and restatement (0.6 years at the 75th percentile)); Linda A. Myers et al., *Restating Under the Radar? Determinants of Restatement Disclosure Choices and the Related Market Reactions* (Apr. 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1309786 [<https://perma.cc/26WJ-3QFJ>] (examining 1773 restatements by U.S. companies between 2002 and 2008 and finding a 1.75 year median length of the restated period (3 years at the 75th percentile) and a 0.5 year median delay between the end of the misreported period and restatement (0.6 years at the 75th percentile)).

101. This possibility is considered at greater depth *infra* Part VI.A.

improve long-term alignment between executives and shareholders. But other distortions might be more subtle and pernicious.

3. The Impact of Tax Gross Ups on the Optimal Tax Treatment of Clawbacks

Thus far I have assumed that, if executives are compensated for net tax costs associated with clawed back compensation, they are compensated ex ante based on the expected net costs and that the executives bear any tax costs associated with particular clawback events. The ideal tax treatment of clawed back compensation in this scenario would provide for full offset of any taxes previously paid on the amount disgorged. Anything less than full offset results in costs that will be passed on to investors ex ante and is inconsistent with an unjust enrichment rationale for clawback adoption ex post. Full offset of taxes on clawed back funds also facilitates the use of clawbacks to manage risk taking incentives, ensures equal tax treatment of similarly situated executives, best promotes the adoption and robust enforcement of voluntary clawback programs, and minimizes distortions in executive pay design.

But what if executives are made whole or “grossed up” for any net tax cost associated with clawed back compensation? Companies have at times grossed up executives for taxes on golden parachute payments, the value of personal use of company aircraft, and other perks.¹⁰² These gross ups are very expensive, and the proxy advisory firms discourage their use,¹⁰³ but they persist. One could imagine, in particular, companies grossing up executives for taxes on clawed back compensation that are not offset on repayment, particularly in the case of no-fault clawbacks imposed on executives lacking any culpability.

102. See, e.g., David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211 (2006) (noting tax gross ups on personal use of corporate aircraft); David I. Walker, *Tax Incentives Will Not Close Stock Option Accounting Gap*, 96 TAX NOTES 851, 855 (Aug. 5, 2002) (discussing gross ups for taxes on excess golden parachute payments).

103. ISS Guidelines, *supra* note 90, at 43 (listing tax gross-ups as a “problematic” pay practice); *Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice*, GLASS LEWIS 38 (2020), https://www.glasslewis.com/wp-content/uploads/2016/11/Guidelines_US.pdf [<https://perma.cc/YFU2-MQWW>] (voicing opposition to the adoption of new executive excise tax gross-ups).

To be clear, I am not talking about grossing up executives for the clawback itself. That would be pointless. The whole idea to clawbacks is to ensure that the executives receive the “right” amount of compensation pre-tax. But by the same token, these executives arguably should not bear a net tax burden on compensation that is returned, and tax gross ups would achieve this. Indeed, a system in which tax gross ups were regularly provided to executives for net taxes on clawed back compensation would eliminate several of the problems or inequities associated with an asymmetric tax regime discussed above. Gross ups of net clawback taxes would facilitate the balancing of risk-taking incentives, ensure equal treatment of executives irrespective of their participation in deferred compensation programs, and avoid punishing innocent executives required to return compensation.¹⁰⁴

But gross ups would not remedy all of the ills associated with net tax costs on clawbacks; some it would exacerbate by increasing the total cost of clawbacks for companies and their executives. If clawbacks resulted in net tax costs and gross ups were anticipated, companies would be further discouraged from voluntarily adopting or even-handedly enforcing clawback provisions, and clawbacks would have an even larger distortionary impact on the design of executive compensation programs.

How expensive are gross ups? To get a sense of the cost, consider the example of an executive who receives a \$1 million bonus in 2019 and pays \$500,000 in federal and state income taxes. (To keep the math simple, we will ignore FICA taxes, which would be recovered on repayment.¹⁰⁵) Suppose the bonus is clawed back in 2020 and that there is no tax credit or deduction for the repayment, such that there is a \$500,000 net tax burden on zero net compensation. Suppose the company commits to making their executives whole for taxes on clawbacks. Because these gross up payments also are taxable as ordinary income,

104. The basic idea here is that fully grossing up executives on any net tax obligations arising from clawbacks is equivalent, from the executives' perspective, to a tax regime providing full offsets. Thus, a number of the benefits associated with a full tax offset regime carry over to a gross up regime. For example, an innocent executive forced to disgorge a bonus under a no-fault clawback provision will be made whole after-tax if her previously paid taxes on the compensation are fully refunded or if her employer grosses her up on any net tax obligation arising from asymmetric tax treatment.

105. See *infra* note 107.

at, we will again assume, a 50% rate, the company will need to pay the executive \$1 million to keep her whole after-tax,¹⁰⁶ an incredible cost for issuing and recouping a \$1 million bonus.

And so, despite the fact that tax gross ups might “solve” several problems associated with a tax regime that does not provide full offset for taxes paid on clawed back compensation, in fact, the possibility that companies might gross up executives for these taxes and incur these costs is actually a compelling argument in favor of full tax offsets for clawbacks.

IV. ACTUAL TAX TREATMENT OF CLAWED BACK COMPENSATION

As this Part explores, the actual tax treatment of clawed back compensation does not necessarily align with the full offset ideal. Although repayments are generally deductible as ordinary and necessary business expenses or as business losses, these deductions are of limited direct use (historically) or no direct use (currently). I.R.C. § 1341 may provide for recovery of taxes previously incurred on clawed back pay in many situations, but § 1341 relief is imperfect and potentially subject to adverse IRS interpretation.

A. Deductibility under I.R.C. §§ 162/165

Let us begin with the paradigm case of an executive who receives compensation in an earlier year in accordance with a bonus plan, but who is required to repay and does repay that compensation in a later year when it is determined, due to an earnings restatement, that the bonus was not actually earned. Under the well-settled “claim of right” doctrine, the executive may not amend her federal income tax return for the earlier year and exclude the repaid compensation, even if the period for amendment remains open, since in the earlier year, the taxpayer had an apparent unrestricted right to the compensation.¹⁰⁷

106. Fifty percent of the \$1 million gross up payment will be consumed by tax, leaving \$500,000 after tax to offset the \$500,000 net employee tax burden of the clawback.

107. *United States v. Lewis*, 340 U.S. 590, 591 (1951) (citing *N. Am. Oil Consol. V. Burnet*, 286 U.S. 417 (1932)). The facts of *Lewis* mirror the typical clawback scenario. *Lewis* received a \$22,000 bonus in 1944 and paid tax on that amount. In 1946, *Lewis* was ordered by a state court to return

However, the taxpayer may be entitled to a deduction in the year of repayment. It is well established that employment constitutes a trade or business, such that ordinary and necessary expenses arising from employment are deductible under I.R.C. § 162.¹⁰⁸ Both court opinions and IRS memoranda have supported deduction of involuntarily repaid compensation in the year of repayment as an unreimbursed business expense under § 162 or as a trade or business loss deductible under § 165(c).¹⁰⁹

Clawback payments should be deductible under §§ 162 or 165 even in circumstances in which the taxpayer's malfeasance triggered the need for the earnings restatement and clawed back compensation. This situation is analogous to one in which an embezzler is apprehended and repays stolen funds. It is well established that an embezzler is entitled to deduct repayment, despite the obvious malfeasance.¹¹⁰ Moreover, clawback payments arising from breach of non-competition, solicitation, or confidentiality agreements are deductible.¹¹¹ The only circumstance in which a clawback payment would not be deductible under §§ 162/165 would be one in which the payment was deemed

\$11,000 to his employer after it was determined that the original bonus amount had been improperly computed. Lewis sued for a refund, which the Court of Claims allowed. The Supreme Court reversed. The claim of right doctrine does not apply to FICA taxes, which when overpaid in a previous year as the result of a clawback provision or otherwise, can be recovered per I.R.C. § 6413 and the regulations thereunder. There is a three-year statute of limitations. *See* Rev. Rul. 79-311, 1979-2 C.B. 25 (holding that § 6413 provides relief for a taxpayer who was required to return compensation advanced in a previous year that exceeded earned commissions); *see also* Barker & O'Brien, *supra* note 6, at 441.

108. Rev. Rul. 79-311, 1979-2 C.B. 25.

109. *Oswald v. Comm'r*, 49 T.C. 645 (1968) (compulsory repayment of excessive compensation pursuant to pre-existing bylaw was deductible as an ordinary and business expense); Rev. Rul. 82-178, 1982-2 C.B. 59 (repaid "income aid payment" was deductible by employee as a business loss per § 165(c)(1)).

110. *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978) (noting that the government did not dispute the taxpayer's deduction of embezzled fund in the year of repayment).

111. Rev. Rul. 67-48, 1967-1 C.B. 50 (allowing deduction under § 165(c)(1) in year of payment of compensation clawed back as a result of taxpayer's breach of an employment contract).

voluntary, such as a case in which the parties entered into the clawback agreement after the triggering event.¹¹² Involuntary clawback payments should generally be deductible under §§ 162/165.

While deductible, the difficulty for executives faced with clawback obligations is that unreimbursed employee business expenses under § 162 and trade or business losses of individuals per § 165(c)(1) are deductible only as miscellaneous itemized deductions (MIDs).¹¹³ Prior to 2018, these deductions were allowed but were restricted; beginning in 2018 and through 2025, these deductions are completely disallowed.¹¹⁴ Luckily, for executives facing clawback obligations, § 1341 will often provide an alternative path to deduction. But before turning to that provision, I will briefly explore the limitations on deductibility of MIDs that applied prior to 2018 and that would potentially apply after 2025.

Prior to 2018, there were three provisions that potentially limited the usefulness of MIDs. First, under § 67, MIDs were allowed only to the extent that the sum of MIDs exceeded 2% of AGI.¹¹⁵ To get a sense of the significance of this “haircut,” I reviewed the data on the deductibility of MIDs for high-income taxpayers as compiled in the IRS’s 2016 Statistics of Income.¹¹⁶ Eighteen percent of returns reporting AGI between \$2 and \$5 million reported MIDs in excess of the 2% of AGI threshold.¹¹⁷ While these taxpayers would have faced no § 67

112. Voluntary repayment of compensation would not be considered an ordinary and necessary expense and would not support a deduction. *Blanton v. Comm’r*, 46 T.C. 527 (1966).

113. I.R.C. § 67(b).

114. TCJA, *supra* note 52, § 11045; I.R.C. § 67(g).

115. For example, a taxpayer with AGI of \$1 million and MIDs of \$25,000 would be able to deduct only \$5,000, as 2% of \$1 million is \$20,000. If the same taxpayer had MIDs of \$20,000 or less, her MIDs would be completely nondeductible.

116. *SOI Tax Stats: Table 2.1: Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2016 (Filing Year 2017)*, <https://www.irs.gov/pub/irs-soi/16in21id.xls> [<https://perma.cc/PC7E-ESAR>] [hereinafter 2016 SOI Table 2.1].

117. *Id.* Compare column 1 (total returns) and column 106 (number of returns with MIDs in excess of the 2% of AGI floor) for the \$2 million to \$5 million AGI band. For comparison, the average realized compensation for “top 5” executives of S&P 1500 companies for 2016 was about \$4.1 million.

“haircut” on an additional deduction for clawed back compensation, the other 82% of taxpayers would have faced a haircut ranging from 0 to 2% of AGI.

Second, under § 68, total itemized deductions (after application of various provision-by-provision haircuts) were reduced by an amount equal to 3% of the excess of AGI over an inflation-adjusted threshold. For high-income taxpayers, this provision increased effective marginal tax rates, but it would have had little impact on the deductibility of clawback payments since most high-income taxpayers had total itemized deductions, without clawback deductions, well in excess of the reduction amount.¹¹⁸

Third, prior to 2018, MIDs were not deductible for purposes of the Alternative Minimum Tax (AMT). According to the IRS SOI, 18% of taxpayers reporting AGI in the \$2 million to \$5 million band were subject to the AMT for 2016.¹¹⁹ For these taxpayers, an additional MID, such as a deduction for a clawback payment, would provide no tax benefit. For the other 82% of taxpayers, the existence of the AMT could have significantly curtailed the tax benefit associated with a clawback payment.

In sum, before 2018, the usefulness to a taxpayer of a deduction for a clawback payment as a MID was often quite limited, principally because of the 2% haircut on MIDs and the non-deductibility of MIDs for purposes of the AMT. The extent to which such a deduction would have offset the tax impact of the prior year’s inclusion would have been essentially random and unrelated to the justifications for permitting or denying tax offsets for clawback payments.

With the enactment of the TCJA, the deductibility under §§ 162/165 of clawback payments is much clearer, and much harsher. MIDs are simply not deductible under the TCJA for tax years 2018

Author’s calculation based on Execucomp data field Total_Alt2, which includes the value of vested stock and the net value of exercised options.

118. 2016 SOI Table 2.1, *supra* note 116. Compare column 1 (total returns) and column 60 (returns with total itemized deductions in excess of the § 68 limitation). In the \$2–\$5 million AGI band, those figures are 101,941 and 101,921, indicating that only 20 taxpayers with AGI at this level reported itemized deductions totaling less than 3% of AGI minus the § 68 threshold.

119. 2016 SOI Table 2.1, *supra* note 116. Compare column 1 (total returns) and column 126 (number of returns subject to the AMT) for the \$2 million to \$5 million AGI band.

through 2025.¹²⁰ Absent § 1341, to which we turn next, an executive making a clawback payment between 2018 and 2025 would receive no tax benefit, no offset against the tax incurred when the compensation was received.

B. Tax Treatment of Clawbacks Under I.R.C. § 1341

When it applies, § 1341 provides a non-miscellaneous itemized deduction or a tax credit for amounts repaid that were previously held under a claim of right. Executives contractually bound to repay compensation have successfully invoked § 1341 to achieve complete recovery of federal income tax previously paid on that compensation. However, § 1341 may not always provide complete recovery for executives subject to clawbacks, and there is a non-trivial question as to whether § 1341 can be utilized by executives making clawback payments in tax years 2018 through 2025. This Subpart explores the application of § 1341 to compensation clawbacks.

1. Section 1341 Overview

Under § 1341, if (1) an item is included in gross income in a prior year because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable in a subsequent year because it is determined that the taxpayer did not have an unrestricted right to the item; and (3) the deduction exceeds \$3000, then, in the year of repayment, the taxpayer is allowed the deduction or takes a credit that is generally equal to the amount of tax incurred due to the earlier inclusion, whichever is more beneficial.¹²¹

The provision is generally viewed as an ameliorating exception to strict annual tax accounting and the claim of right doctrine.¹²² Suppose that a \$10,000 item of income was included in 2018 when the

120. TCJA, *supra* note 52, § 11045; I.R.C. § 67(g).

121. I.R.C. § 1341(a).

122. *United States v. Skelly Oil Co.*, 394 U.S. 678, 680–81 (1969) (“Section 1341 . . . was enacted to alleviate some of the inequities” that followed from the claim of right doctrine and annual accounting); Rev. Rul. 2004–17, 2004–1 C.B. 516 (“Congress enacted § 1341 to ameliorate th[e] inequity in cases” in which a taxpayer receives and includes income in one year and repays and deducts the repayment in a later year).

taxpayer was in a 25% marginal rate bracket and was repaid in 2019 when the taxpayer was in a 12% marginal bracket, and assume that deductibility for the repayment is clear (and fully allowed) under § 162. Under a strict annual accounting system, the \$1200 reduction in tax in 2019 associated with the deduction would not fully make up for the \$2500 in tax associated with the 2018 inclusion. But, of course, a credit for the prior year's incremental tax, allowed under § 1341(a)(5), perfectly offsets the prior year's tax.

Given the disallowance of MIDs under the TCJA, however, § 1341 potentially can do much more for individuals subject to claw-back obligations than merely correcting for rate changes. Assuming that it applies, § 1341 can turn a disallowed deduction into an effective, allowed deduction. Consider the example described in the Introduction. Executive receives a \$1 million cash bonus in 2019 that is based on the achievement of an earnings target, and Executive pays federal income tax on \$1 million. In 2020, the firm restates earnings for 2019, and it is determined based on the restated earnings that Executive was entitled to a bonus of \$700,000. Executive repays the company \$300,000. Assuming that § 1341 applies, Executive would be entitled to a \$300,000 non-miscellaneous itemized deduction in 2020 or a credit for the 2019 tax on \$300,000, whichever is more beneficial. Without § 1341, Executive would have a non-deductible \$300,000 MID.

2. Section 1341 Requirements

Section 1341 does not apply to all repayments of previously taxed income. This Subpart considers two important limitations on its availability: the existence of separate underlying basis for deduction and of an apparent unrestricted right to the income in the year of receipt.

a. Underlying Deductibility

Section 1341 does not create a deduction or credit out of whole cloth. For the provision to apply, there must be an underlying basis for a deduction.¹²³ As discussed above, however, involuntary clawback payments generally are deductible under §§ 162/165, whether the payer is an innocent bystander relative to an earnings restatement, a culpable

123. I.R.C. § 1341(a)(2) (requiring as a predicate that “a deduction is allowable for the taxable year”).

participant in falsifying financials, or the violator of company policies or the terms of an employment agreement. To be sure, a *voluntary* repayment of compensation that would not be deductible under §§ 162/165 would not support a deduction or credit under § 1341.¹²⁴ But modern clawback regimes are almost always involuntary exactions imposed through regulation or pre-existing corporate policy, so “voluntariness” should not be an impediment to the application of § 1341.

The enactment of the TCJA, however, raises a new issue with respect to the underlying deductibility predicate for the application of § 1341 to clawback payments. Specifically, the text of § 1341 requires that “a deduction is allowable for the taxable year” in which the clawback payment is made and that “the amount of such deduction exceeds \$3000.”¹²⁵ But what exactly does this mean? An executive who is required to repay a \$1 million bonus is allowed a \$1 million deduction under §§ 162/165, an amount that far exceeds \$3000. But between 2018 and 2025, this MID is totally disallowed. Do we look to deductibility in the first instance under §§ 162/165 or to ultimate deductibility, taking into account limitations on the deductibility of MIDs? This question could have arisen prior to the enactment of the TCJA, but I find no evidence that it has. This is not too surprising given the infrequency of SEC application of the SOX clawback and the paucity of company-initiated clawback actions under voluntarily adopted programs,¹²⁶ as well as the fact that, before the TCJA, limitations on the deductibility of MIDs would have resulted in ultimate non-deductibility in only a subset of clawback cases. Today, the deductibility of all clawback payments turns on this question.

The Treasury has interpreted the statutory language quoted above as providing for special tax treatment under § 1341 “if, during the taxable year, the taxpayer is entitled under other provisions of [the Code] to a deduction of more than \$3000 because of the restoration” of an item of income included in a prior year under a claim of right.¹²⁷ This language seems most consistent with a restrictive, ultimate deductibility

124. See *supra* note 112 and accompanying text. For example, the IRS would likely challenge the application of § 1341 to a clawback required under a company policy adopted contemporaneously with the triggering event, particularly if the taxpayer was in a position to influence adoption.

125. I.R.C. § 1341(a)(2)–(3).

126. See *supra* notes 17 and 32–34 and accompanying text.

127. Treas. Reg. § 1.1341–1(a)(1).

reading of the statute. An ultimate deductibility reading is also suggested by a Treasury Regulation that explicitly provides that the \$3000 capital loss limitation under I.R.C. § 1211 shall not be taken into account in determining whether deductions that are capital in nature satisfy the requirement that the amount of the underlying deduction exceed \$3000.¹²⁸ There would be no need for such a regulation if analysis ended with deductibility in the first instance. Needless to say, there is no analogous regulation addressing limitations on MIDs.

On the other hand, § 67(b)(9) provides that deductions taken pursuant to § 1341 are not MIDs. When § 1341 applies, and when the current year deduction provides greater tax relief than a prior year credit, the deduction is not subject to § 67 limitations on MIDs. To be sure, the existence of § 67(b)(9) does not resolve the matter. Section 67(b)(9) only comes into play if § 1341 applies. But as Professor Douglas Kahn has argued, § 67(b)(9) clearly reflects a legislative view that repayment of an amount previously held under claim of right was not the “type of situation that warranted the limitations impose[d] on” MIDs and that it is “not plausible” that Congress could have intended that the suspension of MIDs effectively reversed this determination.¹²⁹ Kahn also argues that an ultimate deductibility reading of § 1341 would cause the TCJA’s disallowance of MIDs to impliedly repeal § 67(b)(9), which would then have no application between 2018 and 2025, and he notes the strong presumption against such implied repeal.¹³⁰

I agree with Professor Kahn. The more sensible interpretation of § 1341 is that relief is available if the amount repaid exceeds \$3000 and the repayment is deductible in the first instance under other provisions of the Code.¹³¹ We must recognize the ambiguity, however, and the lack of regulatory guidance or case law on the question. I will assume for the remainder of my analysis that limitations on MIDs do not affect the availability of § 1341, but this must be considered an open question.

128. Treas. Reg. § 1.1341-1(c).

129. Kahn, *supra* note 6, at 1821.

130. *Id.* at 1821 n.9 (citing *Posadas v. Nat’l City Bank*, 296 U.S. 497, 503 (1936); *Branch v. Smith*, 538 U.S. 254 (2003)).

131. See IRS Serv. Ctr. Advice Mem. 1998-026 (Aug. 31, 1998) (“Section 1341 provides that when a substantial amount (more than \$3,000) held under a claim of right is restored by the taxpayer, the taxpayer has two alternative methods of calculating the tax liability for the year of repayment.”).

b. Apparent Unrestricted Right

Section 1341 only applies to amounts included in income in a prior year because of an apparent unrestricted right that later turns out to be untrue.¹³² Embezzlers who are caught, are forced to repay stolen funds in a later year, and find that a change in marginal rates between the year of the theft and the repayment leaves them at a net tax disadvantage may not look to § 1341 for relief because they did not have even an apparent right to the embezzled funds in the first place.¹³³ Unfortunately, beyond this, the IRS and courts have not settled on an interpretation of the language: “appeared that the taxpayer had an unrestricted right,” and the differences in interpretation create uncertainty with respect to the application of § 1341 to clawbacks, and, in particular, to “bad boy” clawbacks.

In a series of Revenue Rulings promulgated in the 1950s and 1960s, the IRS interpreted the requirement that a taxpayer have an apparent unrestricted right to an item in an earlier year to preclude the application of § 1341 to situations in which a taxpayer had an *actual* unrestricted right to the item but was required to repay as a result of subsequent events.¹³⁴ For example, Revenue Ruling 67–48 dealt with a taxpayer who was contractually obligated to repay prior year compensation as a result of his breach of an employment contract.¹³⁵ The ruling held that the repayment was deductible under § 165, but not under § 1341, because the taxpayer had an actual unrestricted right to the compensation at the time of receipt and the repayment obligation “arose as a result of subsequent events,” i.e., the breach of his employment contract.¹³⁶

132. I.R.C. § 1341(a)(1) (“an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item”).

133. *McKinney v. United States*, 574 F.2d 1240, 1243 (5th Cir.1978); *Yerkie v. Comm’r*, 67 T.C. 388, 392 (1976).

134. Rev. Rul. 69–115, 1969–1 C.B. 50; Rev. Rul. 68–153, 1968–1 C.B. 371; Rev. Rul. 67–437, 1967–2 C.B. 296; Rev. Rul. 67–48, 1967–1 C.B. 50.

135. Rev. Rul. 67–48, 1967–1 C.B. 50.

136. *Id.* The essence of the IRS’s argument was that in a situation such as this the taxpayer does not hold the funds under a claim of right and does not include the item in income under a claim of right but simply as income from whatever source derived.

More recently, the IRS has softened its interpretation somewhat, arguing that the determination of whether the taxpayer appeared to have an unrestricted right to the income must be based on facts in existence at the time of receipt and not facts that arose subsequently.¹³⁷ For example, in *Dominion Resources v. United States*, after 1986 tax reform reduced corporate tax rates, a utility was required to refund \$10 million that had been collected from customers to cover deferred tax liabilities.¹³⁸ The IRS argued that § 1341 was inapplicable because, based on the facts in existence in the year of receipt, the utility did not *appear* to have an unrestricted right to the income; it had an *actual* right to the income.¹³⁹

Some courts have embraced this approach.¹⁴⁰ Other courts have rejected the IRS's interpretation of "apparent unrestricted right" and have adopted a more liberal reading, requiring only that "the requisite lack of an unrestricted right to an income item permitting deduction [in a subsequent year] must arise out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer."¹⁴¹ In the *Dominion Resources* case discussed above, for example, the Fourth Circuit panel concluded that the utility's repayment arose out of the same circumstances as the original collection—the creation and maintenance of a reserve for deferred income taxes—and thus satisfied the "apparent unrestricted right" requirement for application of § 1341.

How does this disagreement affect the availability of relief under § 1341 for individuals making clawback payments? The answer depends on the circumstances.

Let us begin with the case of an executive who is required to restore a bonus to her employer under a no-fault clawback arrangement that has been imposed through legislation or contract and who, in fact, bore no responsibility for the events triggering the earnings

137. Barker & O'Brien, *supra* note 6, at 431–32 (discussing the IRS's shift from a "subsequent events" test to a "facts in existence" test).

138. *Dominion Res., Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000).

139. *Id.* at 364.

140. See, e.g., *Cinergy Corp. v. United States*, 55 Fed. Cl. 489 (2003) (holding that § 1341 was not available to a utility that had been required to refund deferred taxes to its customers as a result of subsequent settlement with its regulators).

141. *Dominion Res.*, 219 F.3d at 367 (quoting *Pahl v. Comm'r*, 67 T.C. 286, 290 (1976) (quoting *Blanton v. Comm'r*, 46 T.C. 527, 530 (1966))).

restatement, an innocent bystander, so to speak. Section 1341 relief should not be barred by any of these interpretations of “apparent unrestricted right.” Clearly, under the “same circumstances” test adopted in *Dominion Resources* and other cases, clawbacks of previously awarded excessive bonuses resulting from earnings restatements arise out of the “circumstances, terms, and conditions” of the previous year payment. The net effect of the clawback in these cases is essentially a redetermination of the bonus due the executive for the prior year. As such, these cases satisfy the “apparent unrestricted right” prong of § 1341 as this language has been interpreted by these courts.

The repayment, moreover, is only trivially connected with a subsequent event and is dictated by facts in existence at the time of receipt. The events that determined both the original payment and the clawback, e.g., the achievement of certain earnings targets, occurred at the same time; it was only the redetermination of the earnings result that occurred in a later period. Thus, these cases should also satisfy the IRS’s more restrictive interpretations of “apparent unrestricted right.”

Despite this, the government has argued that § 1341 relief is unavailable under just these sorts of facts. For example, the taxpayer in *Van Cleave v. United States* was the majority shareholder of a closely held corporation who repaid a portion of his compensation, pursuant to a pre-existing bylaw and agreement, after the IRS determined that the portion was excessive and not deductible by the corporation.¹⁴² The government argued that § 1341 did not apply because Van Cleave had an actual unrestricted right to the compensation in the year of receipt (as opposed to an apparent unrestricted right) and that the repayment obligation flowed from a subsequent event, the determination that the compensation was excessive.¹⁴³

The Sixth Circuit held for the taxpayer in *Van Cleave*, disagreeing with the government’s contention that Van Cleave had an actual unrestricted right to the compensation in the year of receipt.¹⁴⁴ It seems clear that the government overreached in *Van Cleave*. Although the IRS determined in a subsequent year that Van Cleave’s compensation was excessive in the year of payment, fundamentally the payment was excessive in the year of payment irrespective of future events. These facts are distinguishable from those in Rev. Rul. 67–48 where

142. *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983).

143. *Id.* at 197.

144. *Id.*

the repayment obligation arose from a breach of an employment contract that occurred in a year subsequent to the receipt of the income. Moreover, the facts of *Van Cleave* would clearly satisfy the IRS's slightly more lenient "facts in existence" standard for the same reason. The bottom line is that the "apparent unrestricted right" requirement should not be an obstacle to the application of § 1341 to "innocent" executives making no-fault clawback payments.

Slightly less certain, but still reasonably certain under all tests, is the application of § 1341 to SOX mandated clawbacks from CEOs and CFOs of bonuses, incentive-based, and equity-based pay received within 12 months of the filing of a subsequently restated financial statement and profits on company stock sold within the same period.¹⁴⁵ While these clawbacks exceed those necessary to eliminate the benefit from the misstated financials, they arise out of the "circumstances, terms, and conditions" of the previous year payments, in the sense that the misstated financials would have had a bearing on bonuses and incentive/equity pay and on the price at which shares were sold, and given SOX, the terms and conditions under which CEOs and CFOs keep their compensation now include the absence of financial restatements. Certainly it cannot be said that these perhaps over-broad SOX clawbacks "bear[] no relationship" to the original compensation.¹⁴⁶

Moreover, these SOX-mandated clawbacks are predicated on facts in existence in the year of receipt and do not arise from subsequent events, or certainly not in the way that a breach of contract in year two is a subsequent event relative to receipt of compensation in year one. Once again, while the restatement occurs in a later period, the critical underlying event—the misstated financial report—occurs before the compensation is received, and, again, the assumption is that the misstated financials affected the amount of compensation.

In the discussion thus far, I have assumed that an executive facing a clawback obligation was not personally involved in fraudulent activity that prompted an earnings restatement. But what if she was? Recall that employer-initiated clawbacks are often limited to executives directly responsible for a triggering event. That triggering event

145. SOX, *supra* note 1, § 304(a).

146. *Cf. Bailey v. Comm'r*, 756 F.2d 44, 47 (6th Cir. 1985) (rejecting the application of § 1341 to a fine, later converted into restitution, paid for violation of a consent decree as the violation did not arise out of the same circumstances as the taxpayer's original receipt of salary and dividends).

might be a restatement flowing from a good faith error, or it could result from fraud.

Although there are no cases or Revenue Rulings directly on point, presumably an executive established to have fraudulently stated earnings would not be entitled to rely on § 1341 to recover taxes on clawed back compensation based upon the fraudulent earnings. The bar to the application of § 1341 would be the lack of an apparent unrestricted right to the compensation in the year of payment, under any interpretation of “apparent unrestricted right.”¹⁴⁷ For the purposes of § 1341, the receipt of a bonus based on knowingly inflated earnings is akin to embezzlement. The Fifth Circuit has held that it is the appearance *to the taxpayer* that controls,¹⁴⁸ and, as the Federal Circuit has stated “[w]hen a taxpayer knowingly obtains funds as the result of fraudulent action, it simply cannot appear from the facts known to him at the time that he has a legitimate, unrestricted claim to the money.”¹⁴⁹

Finally, what about the application of § 1341 to “bad boy” clawbacks? Consider a company policy requiring executives to repay or return all bonuses, equity awards, shares derived from equity awards, and profits from share sales within the last five years if the officer breaches any non-competition, non-solicitation, or confidentiality agreement. Suppose an executive breaches one of these agreements and makes the requisite payments and transfers. Recall that while the SOX, TARP, and Dodd-Frank clawback provisions are focused on financial accounting restatements, employer-initiated clawbacks often are predicated upon this sort of misconduct. Presumably, § 1341 would not apply to such clawbacks under the IRS’s subsequent events test since these clawbacks are indeed triggered by events (competition, solicitation, breach of confidentiality) that occurred after the year in which the clawed back compensation was paid. These cases seem to fit squarely within the confines of Revenue Ruling 67–48.¹⁵⁰ Further, these clawbacks do not arise wholly from facts in existence at the time of receipt. The risk of clawback was known, but the behavior that triggered the clawback occurred later. As such, these clawbacks also fail the facts in existence standard for determining an apparent unrestricted right.

147. See Melone, *supra* note 6, at 93 (reaching the same conclusion).

148. McKinney v. United States, 574 F.2d 1240, 1243 (5th Cir.1978).

149. Culley v. United States, 222 F.3d 1331, 1335 (Fed. Cir. 2000).

150. *Supra* notes 134–136 and accompanying text.

But do these “bad boy” clawbacks satisfy the same circumstances test adopted by several circuit courts of appeal? I think that they do. An executive receives her compensation subject to the clawback policy. Her right to retain the compensation is contingent on compliance with its terms. The repayment does not arise “from a different commercial relationship or legal obligation.”¹⁵¹ The repayment is “a counterpart or complement of the item of income originally received.”¹⁵²

In sum, it appears that a taxpayer has an apparent unrestricted right to compensation, under any interpretation, and may invoke § 1341 (assuming other tests are met) in innocent restatement cases, but may not invoke § 1341 if culpable for fraudulent earnings that trigger restatements, again under any theory. By contrast, § 1341 appears to reach “bad boy” clawbacks under the “same circumstances” test but not under the IRS’s more restrictive tests.

3. Further § 1341 Asymmetries

While § 1341 should provide a deduction or credit for an executive faced with a clawback obligation under many circumstances, the provision was not designed to perfectly offset the earlier tax payment, and it does not always do so. This Subpart briefly describes some asymmetries.

When it applies to clawed back cash compensation, § 1341 provides the taxpayer with the better of a current year deduction or what is effectively a credit for the prior year payment, and it can result in windfalls for executives. Suppose an executive receives a \$1 million bonus in 2019 that she is required to repay in 2020 as a result of an earnings restatement. Suppose her marginal federal income tax rate was 40% in 2019 and 35% in 2020. She would have paid \$400,000 in federal tax on the bonus in 2019 and would effectively receive a credit for that amount in 2020, as the tax reduction associated with a 2020 deduction would be less (\$350,000).¹⁵³ In this case, we get a perfect offset of the previous year’s tax burden. Suppose, however, that the marginal rates were flipped: 35% in 2019 and 40% in 2020. In this case, the executive would make a \$50,000 tax profit on the 2019 inclusion (\$350,000 tax cost)

151. *Pennzoil-Quaker St. Co. v. United States*, 511 F.3d 1365, 1370 (Fed. Cir. 2008).

152. *Id.*

153. I.R.C. § 1341(a)(5).

coupled with a 2020 deduction (\$400,000 tax benefit), since the 2020 deduction benefit exceeds the credit for 2019 tax paid.¹⁵⁴

The SEC's proposed clawback rule implementing Dodd-Frank would require the forfeiture of shares issued as incentive compensation, if still held as shares, or the sale proceeds, if the shares have been sold.¹⁵⁵ Forfeiture of stock-based compensation could result in a disadvantageous tax asymmetry for executives subject to clawbacks.

Suppose in 2019 an executive receives vested stock worth \$100,000 as the payout from a performance share plan. The fair value will be taxed at that time. Now suppose that the shares are clawed back in 2020 following an earnings restatement. Suppose that the executive retains and forfeits the shares. First, suppose that the shares are worth \$120,000 at forfeiture. The current year deduction under § 1341(a)(4) would be \$100,000, the basis of the stock.¹⁵⁶ The 2019 adjustment under § 1341(a)(5) would be exclusion of \$100,000. Although the stock forfeited is worth \$120,000, per Treasury Regulations the amount excluded under § 1341(a)(5) is the lesser of the amount restored and the amount included in the prior year.¹⁵⁷ In this scenario, we have a perfect offset of earlier included income under either § 1341(a)(4) or § 1341(a)(5).¹⁵⁸

Now suppose that in 2020 the fair value of the forfeited stock is \$80,000. The executive would still be entitled to a current year deduction of her basis in the stock of \$100,000 under § 1341(a)(4).¹⁵⁹ But under § 1341(a)(5), she would be permitted to exclude only \$80,000 in recalculating her 2019 tax liability, not \$100,000.¹⁶⁰

If it turns out that marginal tax rates are the same or higher in 2020, such that § 1341(a)(4) controls, the executive enjoys a full tax offset for earlier paid tax. But if marginal rates are lower in 2020, such that § 1341(a)(5) controls, the cases are not symmetrical. An executive would enjoy a full offset of previously paid tax in the increasing stock price scenario but something less than a full offset in the declining share price scenario.

154. I.R.C. § 1341(a)(4).

155. See SEC Release, *supra* note 3, at 46.

156. Treas. Reg. § 1.83-1(e).

157. Treas. Reg. § 1.1341-1(d)(2)(i).

158. This is a sensible result because the executive has not paid tax on the \$20,000 unrealized gain.

159. Treas. Reg. § 1.83-1(e).

160. Treas. Reg. § 1.1341-1(d)(2)(i).

To be sure, this disadvantageous result could be avoided if an executive can sell the shares and forfeit the cash.¹⁶¹ In the declining share price example, an executive who sold \$100,000 basis shares for \$80,000 and forfeited \$80,000 cash would still be permitted to exclude \$80,000, the amount forfeited, but she would also have the tax benefit of a \$20,000 capital loss. Generally, executives can sell vested shares, in which case the differential treatment of share and cash forfeiture would largely be a trap for the unwary.

Also, to be sure, any asymmetries in the application of § 1341 to clawed back compensation arising from marginal tax rate changes are likely to be a second order concern. While achieving fairness for taxpayers otherwise disadvantaged by rate changes occurring between receipt and repayment of amounts held under claim of right was the rationale for the enactment of § 1341, assuming it applies in the claw-back context, the overwhelming value of § 1341 lies in the avoidance of the prior limitations on and current bar to the deductibility of MIDs under I.R.C. § 67.

V. HOW WELL DOES ACTUAL CLAWBACK TAX TREATMENT ACHIEVE OPTIMAL TAX TREATMENT?

This Part compares the current tax treatment of clawed back funds with the various objectives discussed in Part III. I conclude that while one could argue that the most probable tax treatment under § 1341 is roughly consistent with unjust enrichment and deterrence goals, a tax regime providing for full offset of tax previously paid on returned compensation in all cases would be superior.

A. Unjust Enrichment

Under an unjust enrichment-focused approach, executives facing claw-back obligations would forfeit unearned compensation and would face no net tax burden as a result of the returned pay. To be sure, taxes aside, not all clawbacks work this way. The SOX clawback goes beyond remedying unjust enrichment by requiring recoupment of all incentive pay within a window, not just excess pay, whereas the Dodd-Frank

161. To repeat, the Dodd-Frank clawback provision envisions forfeiture of cash proceeds received on disposition of equity compensation subject to clawbacks.

clawback design—requiring forfeiture of excess pay associated with the misstated financials—does appear to focus on eliminating unjust enrichment. Employer-adopted clawbacks reflect both approaches.¹⁶²

To the extent that § 1341 provides a full offset for clawed back compensation, it is consistent with an unjust enrichment–focused approach. Recall that, as interpreted by the courts in cases like *Van Cleave* and *Dominion Resources*, § 1341 would apply to “bad boy” clawbacks and to restatement-driven clawbacks, except for cases in which executives are culpable in financial misstatement. In cases in which executives are culpable, § 1341 would not apply, and under current law these executives would receive no deduction or credit for tax paid on the compensation that was later returned, creating a tax penalty, not just a corrective for unjust enrichment. Moreover, the IRS is likely to be less generous than the courts in its application of § 1341, refusing, for example, to apply it to “bad boy” clawbacks that fail its “apparent unrestricted right” test. This too would be excessive under an unjust enrichment approach. As noted above, even when § 1341 applies, it does not always result in a perfect tax offset, but those differences seem secondary (from an unjust enrichment–remedying perspective) to its failure to provide any offset in certain situations.

To be sure, the argument that clawback rules should prevent unjust enrichment but do no more is most compelling in the case of no-fault, restatement-driven clawbacks. So, to that extent, one could argue that the fit between § 1341 treatment and the unjust enrichment ideal is not far off the mark.

B. Deterring Financial Misreporting

By allowing for full tax offsets with respect to restatement-triggered clawbacks, except for cases in which executives are culpable in financial misstatement, § 1341 appears to be reasonably consistent with an objective of deterring financial misreporting. Although the loss of a deduction for falsifiers goes beyond unjust enrichment, at first blush, at least, this loss raises few concerns with over-deterring accounting fraud. The loss of the deduction creates a penalty for misreporting when detected, and the optimal amount of accounting fraud is zero.

But all is not quite so simple. An executive faced with a clawback obligation in the wake of a restatement might be a wholly

162. See *supra* Part II.

innocent bystander, having nothing to do with the misstatements whatsoever, an obviously culpable fraudster, or something in between, perhaps an executive responsible for financial reporting who has no knowledge of the underlying misstatements. Or perhaps her knowledge is unclear. Or perhaps the legitimacy of the original financials was debatable. In which of these cases would we say that the executive did not have an apparent unrestricted right to the income and would not be entitled to tax offsets under § 1341? At the very least, reliance on § 1341 for tax offsets for restatement-triggered clawbacks introduces potential litigation into the determination of an executive's culpability. At most, the lack of tax offsets for culpable (whatever that means) financial misreporting could result in overly conservative reporting practices, as discussed in the next Subpart.

C. Mitigating Excess Risk-Taking Incentives

Although we desire zero accounting fraud, not all aggressive financial reporting positions are fraudulent, and shareholders may benefit from reasonable, aggressive reporting. The unavailability of § 1341 for culpable mis-reporters could inhibit that healthy activity.

Some clawback provisions target substantive risk taking with triggers ranging from misconduct to violation of fiduciary duty to detrimental activity to explicit excessive risk taking.¹⁶³ These triggers are analogous to the “bad boy” clawback triggers previously discussed—violation of non-competition, non-solicitation, or non-disclosure agreements. Under some readings of § 1341, the provision would allow for tax offsets for clawbacks triggered by such activity. The IRS's more restrictive reading might not. Meanwhile, it is difficult to design an optimal deterrence scheme for “excessive” risk taking. All we know is that this is an activity that can be over-deterred. To the extent that firms optimally, or at least thoughtfully, design forfeiture for excessive risk-taking provisions, they are more likely to do so on a pre-tax than post-tax basis, particularly given variation in executive tax positions, as discussed below. Thus, a scheme that fails to fully offset taxes on clawed back compensation poses a real risk of over-deterrence.¹⁶⁴

163. BBBCS, *supra* note 4, at 45 (misconduct and negligence of fiduciary duty (52%); detrimental activity (11%); excessive risk taking (1%)).

164. This is not to suggest that deterrence of fraudsters is an unimportant goal. Tax rules, however, would seem to be a relatively ineffective and

D. Fairness

As discussed above,¹⁶⁵ the fairest scheme for taxing clawbacks—the approach that is most consistent executive to executive and least likely to punish innocents—would provide full offsets for taxes on clawed back compensation. Given the fact that some executives may meet clawback obligations out of pre-tax funds (untaxed equity or deferred compensation) while others have access only to after-tax funds, anything less than full offset can result in unintentional inconsistency. Moreover, except in a system in which culpability is incontrovertible, tying offsets to culpability, as § 1341 does, will inevitably result in some mistaken deduction disallowances, and/or the need for litigation.

E. Dynamic Responses

How we tax clawbacks matters. If full tax offsets are not allowed, companies will be less likely to adopt clawback provisions voluntarily, will tend to adopt weaker clawback provisions, and will tend to enforce clawback provisions less strictly. Section 1341 approaches full offset, but the gaps, or perhaps more importantly, the risk of gaps in its coverage is likely to influence firms in the directions I've just outlined.

But what about mandatory clawbacks? Surely firms can't avoid these, and so a scheme that provides less than full offset of taxes paid on clawed back funds shouldn't have negative behavioral consequences, right? Wrong. First, to the extent that companies have discretion in enforcement, they will use that discretion to a greater degree if tax offsets might not be available. Second, if tax offsets are incomplete or uncertain, companies might expend greater effort or cost in designing compensation to minimize the risk that their executives will face clawbacks.¹⁶⁶ Third, executives facing the possibility of asymmetric tax treatment may make greater use of deferred compensation, which might be good or bad, but is

inefficient tool. There are other means of deterring accounting fraud, including SEC sanctions, reputational harm, potential loss of employment, etc. There is no reason to rely on the tax code to deter fraudsters, and given the risk of mistake, accounting fraud is better not enforced through the tax rules applicable to clawbacks.

165. See *supra* Part III.C.

166. This incentive exists even with full tax offsets, but the incentive is greater if full offsets are not assured.

certainly distorting. Fourth, executives are likely to demand and receive additional compensation to make up for the tax risk associated with potential clawbacks or to demand gross-ups (explicit or implicit) for any tax losses actually incurred. All of which is suboptimal.

VI. OTHER RESPONSES TO LIMITED DEDUCTIBILITY OF CLAWBACK PAYMENTS

This Part considers two other potential dynamic responses to limited deductibility of clawback payments under current tax rules that merit somewhat fuller exploration. First, some companies and executives may opt for a “self-help” solution to limited clawback payment deductibility electing to defer receipt of and tax on some incentive pay. This approach will “work” for tax purposes, but care must be taken to avoid incurring a § 409A penalty tax on clawed back deferred compensation. Second, some companies might attempt to avoid deduction limitations by reducing compensation of executives subject to clawback obligations in subsequent years instead of requiring these executives to actually repay compensation. In my view, this approach is unlikely to “work” for tax purposes.

A. Clawbacks of Deferred Compensation and I.R.C. § 409A

Firms and executives can avoid the problem of inadequate tax offsets for clawback payments by ensuring that any clawed back compensation has not been subjected to tax in the first place. This could be done by extending the vesting periods for incentive compensation beyond likely clawback windows. It could also be accomplished by deferring sufficient compensation, pursuant to employer-operated nonqualified deferred compensation (NQDC) programs, to cover any conceivable clawback obligation.¹⁶⁷ However, while these strategies avoid the possibility of executives paying unrecoverable tax on ultimately clawed back compensation, they also raise potential headaches under I.R.C. § 409A.

Enacted in the wake of the Enron debacle and other corporate scandals, § 409A tightens the rules on NQDC and imposes significant penalties on NQDC that fails to comply with those rules.¹⁶⁸ NQDC is

167. See *supra* note 61 and accompanying text.

168. The primary requirements under § 409A have to do with the timing of elections to defer compensation (§ 409A(a)(4)) and the timing of

defined very broadly under § 409A to include equity compensation, if not exempted, as well as traditional NQDC plans, such as elective non-qualified defined contribution plans and nonqualified defined benefit pension plans.¹⁶⁹ Although nonqualified stock options and restricted stock also provide for deferral, the regulations under § 409A specifically exempt these equity compensation instruments from the rules,¹⁷⁰ but these equity instruments are in decline at public companies.¹⁷¹ The newly ascendant equity instruments—restricted stock units and performance shares—may be subject to § 409A, depending on their design.

Let's focus on elective NQDC, which is clearly subject to § 409A. Suppose an executive makes an election to defer her 2018 annual bonus under her firm's elective NQDC plan. If a number of well-defined rules are followed, the executive will not be taxed on that bonus in 2018 but will be taxed on the bonus and any investment earnings on that bonus at payout.¹⁷² In order to satisfy § 409A, in particular, the payout must be made on a predetermined date or dates or upon the occurrence of another § 409A-sanctioned event, such as death, disability, or severance.¹⁷³ Payout may not be accelerated.¹⁷⁴

Suppose the 2018 bonus is clawed back in 2020. The good news, tax-wise, is that because the deferred bonus was not taxable (to the executive or the firm) in 2018, no offsets are required in 2020. The concern is whether the transfer out of the executive's NQDC account

payouts (§ 409A(a)(2)). NQDC that does not comply with the § 409A rules is subject to taxation at vesting and to an additional 20% penalty tax. I.R.C. § 409A(a)(1).

169. These plans are analogues of more familiar tax-preferred qualified defined contribution plans, such as 401(k) plans, and qualified defined benefit pension plans.

170. Treas. Reg. § 1.409A-1(b)(5)(i)(A) (nonqualified stock options); Treas. Reg. § 1.409A-1(b)(6) (restricted stock).

171. See Walker, *supra* note 98, at 405–08.

172. See Miller, *supra* note 61, at 255–69. In order to achieve tax deferral, a nonqualified deferred compensation obligation must represent only an “unfunded and unsecured promise to pay money or property in the future” (Treas. Reg. § 1.83-3(e)), participants must be “general unsecured creditors” of the employer (Rev. Proc. 92-65, 1992-2 C.B. 428), and the arrangement must satisfy the requirements of I.R.C. § 409A.

173. I.R.C. § 409A(a)(2).

174. I.R.C. § 409A(a)(3).

back to the company represents an impermissible payout, acceleration, or substitution under § 409A.

I am not aware of any authority on this question. Some practitioners have recommended drafting clawback policies to pull funds from sources other than NQDC in order to avoid potential problems under § 409A.¹⁷⁵ Other practitioners, however, recommend drafting clawback provisions to provide for the “forfeiture” of NQDC that is clawed back, rather than the “repayment” of such compensation.¹⁷⁶ Under the Treasury Regulations, a forfeiture of NQDC is not treated as a payment and should not trigger the negative repercussions associated with non-complying payments under § 409A.¹⁷⁷

The bottom line here is that while NQDC looks like the solution to the potential pitfalls associated with relying on § 1341 to recover taxes previously paid on clawed back compensation, there are also potential pitfalls to using this approach that are created by § 409A. Ideally, the Treasury would amend the regulations to include clawback payments in its list of permissible distribution events, or the Treasury or IRS would at least provide guidance confirming that a clawback forfeiture of NQDC does not trigger adverse consequences under § 409A.

175. Jeff Haughey & Alan Kandel, *SEC Clawback Rules Have Executive Tax Consequences*, SEC. L. INSIDER (Oct. 5, 2015), <https://web.archive.org/web/20160410230554/http://www.securitieslawinsider.com/2015/10/sec-clawback-rules-have-executive-tax-consequences/> [https://perma.cc/W9MY-N9WF]; Katherine Blostein, *Clawbacks: Trends and Developments in Executive Compensation*, ABA 7 (Mar. 25, 2010), https://www.americanbar.org/digital-asset-abstract.html/content/dam/aba/administrative/labor_law/meetings/2010/2010_err_014.pdf [https://perma.cc/L3WF-AD3Q].

176. Joshua A Agen & Leigh C. Riley, *Compensation Clawbacks and Code Section 409A Acceleration*, FOLEY (Jan. 8, 2014), <https://www.foley.com/en/insights/publications/2014/01/compensation-clawbacks-and-code-section-409a-accel> [https://perma.cc/YBB9-CHZL]; Rosina B. Barker, *Compensation Clawbacks: Tax Consequences for Issuers and Executives*, IVINS PHILLIPS BARKER 15 (Oct. 7, 2015), https://www.ipbtax.com/media/news/333_Barker%20Clawbacks%20_2_.pdf [https://perma.cc/24GF-XPSH].

177. Treas. Reg. § 1.409A-3(f) (providing that a forfeiture of an amount of deferred compensation will not be treated as a payment as long as the participant does not receive an offsetting payment).

B. Clawback Holdbacks

In implementing the Dodd-Frank clawback or their own voluntarily adopted clawback schemes, companies might arrange to reduce the pay of executives subject to clawback obligations in a future year by the amount of the obligation in lieu of requiring these executives to actually repay the clawback amount.¹⁷⁸ Implementing clawbacks through this “holdback” technique might be administratively convenient for companies and less onerous for their executives. Moreover, one might think that since the executives would actually repay no compensation, the tax issues discussed above might disappear. The tax treatment of holdbacks is uncertain, however, and in my view, unlikely to be advantageous vis-à-vis the “traditional” clawback approach.

Consider the example from the Introduction. Executive receives a \$1 million bonus in 2019 and pays tax on that amount. Following a 2020 earnings restatement, it is determined that the bonus should have been \$700,000. Under the traditional clawback approach, Executive would be required to return \$300,000 to the company and her 2020 compensation would be unaffected. Under the holdback approach, Executive would make no transfer to the company, but her 2020 compensation would be reduced by \$300,000. Suppose she would otherwise have been entitled to an \$800,000 bonus in 2020. Her actual 2020 bonus would be \$500,000.

If the reason for the 2020 pay reduction is ignored and taxes are simply applied to the amounts paid in the various years, this holdback approach would eliminate any significant tax concerns. Executive would pay tax on the \$1 million bonus in 2019 and on a \$500,000 bonus in 2020. If her marginal tax rate is the same in the two years, this is essentially equivalent to paying tax on \$700,000 in 2019 and \$800,000 in 2020.¹⁷⁹

But would the IRS tax the cash flows like this or would it disaggregate the transactions and tax them consistently with the traditional clawback approach? That is, require Executive to include \$1 million and

178. Obviously, this technique would be feasible only with respect to executives who remain employed by the company. Recall that the Dodd-Frank clawback applies to “current and former” executives who received incentive pay within the requisite window. *See supra* text accompanying note 20.

179. I am ignoring the modest time value of money difference between taxes owed for 2019 and 2020.

\$800,000 in compensation in 2019 and 2020 respectively and allow Executive a \$300,000 deduction in 2020 subject to the limitations on MIDs and the potential application of § 1341? I am not aware of any persuasive authority on this exact question, but there are doctrinal and policy reasons to doubt that this holdback approach would improve the overall tax picture for executives and their companies.

First, assuming that deduction of actual clawback payments does not fully offset the tax incurred on the original receipt, ignoring the underlying reality behind the holdback approach would result in inconsistent treatment of companies or executives employing the two techniques. For example, former executives subject to the Dodd-Frank clawback would not be able to avail themselves of the holdback option and might be penalized, effectively, vis-à-vis executives who remain employed. Of course, if deduction of clawback payments does result in a full offset of previously incurred tax, taxing holdbacks according to the cash flows would not result in an inequity.

Second, the IRS could justify a decision to disaggregate the reduced \$500,000 net compensation in 2020 in my example into \$800,000 of income to Executive combined with a \$300,000 payment to the company by analogy to I.R.C. § 7872's treatment of no/low interest loans to employees or to cases such as *Collins v. Commissioner*.¹⁸⁰ When § 7872 applies to no or low interest loans from an employer to an employee, the employee is taxed as if the employee paid a market rate of interest to the employer and the employer simultaneously paid the employee the same incremental amount in additional compensation. This disaggregation is analogous to deeming \$300,000 as additional compensation in 2020, offset in my example by a deemed \$300,000 clawback payment. In *Collins*, the taxpayer, an employee at an off-track betting parlor, entered bets totaling \$80,000 on his own behalf, without paying for them. After incurring net losses of \$38,000, he turned himself in to his boss, turned over his \$42,000 of winning tickets, and was fired. Collins argued that he suffered an overall tax loss, but the IRS argued and the court held that the transactions should be disaggregated into two transactions: (1) embezzlement of \$80,000 and repayment of \$42,000, and (2) a non-deductible gambling loss of \$38,000. Again, this disaggregation process seems analogous to the likely treatment of compensation held back to cover an obligation to repay compensation.

180. *Collins v. Comm'r*, 3 F.3d 625 (2d Cir. 1993).

Third, there is at least one (admittedly non-precedential) private letter ruling in which the IRS disaggregates a compensation holdback in just such a scenario. In PLR 9103031, one group of employees was determined to have received excessive bonuses, and the company was required to reduce their subsequent wages by the excess amount in order to create a pool of funds to distribute to another group of employees who had received inadequate bonuses. The IRS held that the amounts subtracted from the wages of the over-compensated employees would be included in the income of these employees and that these “employees may take account of repayment of wages received in a prior year for federal income tax purposes only by taking the repayment as an itemized deduction . . .”¹⁸¹

In sum, while it is possible that a clawback holdback approach might avoid adverse tax consequences associated with actual repayments in situations in which executives facing obligations remain employed by the company, it would be unwise to rely on this technique and favorable tax treatment as a global solution to the issue.

VII. CONCLUSION AND THE ROAD AHEAD

From a corporate governance perspective, I prefer strict, comprehensive, no-fault clawbacks of excess pay associated with earnings restatements. I have never understood why it isn’t obvious that unearned compensation should be returned to shareholders. Of course, shareholders will pay for this in the sense that executives will demand greater compensation to offset the clawback risk. This is fair enough. Another way to look at the current situation is that, absent clawbacks, an element of executive pay is the opportunity to retain unearned compensation. It is fairer and more efficient to tie incentive pay to actual results and compensate executives *ex ante* for eliminating these windfalls.¹⁸²

This perspective is consistent with an unjust enrichment approach to clawbacks and clawback taxation and to a tax scheme that provides for full offset of any tax previously paid by executives on

181. P.L.R. 91-03-031 (Jan. 18, 1991) (citing Rev. Rul. 79-311, 1979-2 C.B. 25).

182. See Fried & Shilon, *supra* note 6, at 728 (arguing that allowing executives to profit from misstated financials—whether random or purposeful—is an inefficient form of compensation).

compensation that is subsequently returned. Deterrence rationales for clawbacks are also plausible, and these rationales might justify a more punitive tax scheme, i.e., something less than full offset, but other considerations—fairness, consistency, minimizing distortions and litigation—weigh against an asymmetric tax regime.

So, what is to be done? Ideally, Congress would adopt legislation that would provide individuals with a credit for tax paid on compensation that is subsequently returned to their companies as a result of a clawback. Ideally, this tax treatment would apply to all clawbacks irrespective of culpability and the basis for the clawback (restatement, breach of contract, etc.).

Under current tax rules, the recovery of taxes paid by executives on clawed back compensation is basically an all or nothing proposition—if § 1341 applies, the executive will be made whole; if § 1341 does not apply, the deduction will be completely disallowed as a miscellaneous itemized deduction. In the case of restatement-based clawbacks, the difference between full offset and no offset turns on culpability. The dollars at stake will be large, and one can expect extensive litigation over culpability under such a regime. Thus, while limited or even no recovery of tax by fraudsters might be reconciled with a deterrence rationale for clawbacks, distinguishing between culpable and non-culpable executives would lead to costly and unnecessary litigation over culpability. There are better ways to deter fraud.

I am relatively unconcerned about clawbacks for “bad boy” behavior, which are essentially liquidated damages provisions. Presumably, if firms and executives face asymmetric tax treatment with respect to clawbacks, they can find other, more tax efficient ways, of deterring these behaviors. Nonetheless, my inclination would be to provide for full tax offsets for these clawbacks as well because this seems to best facilitate private ordering and because I cannot see why the government should take a cut out of such arrangements through asymmetric tax treatment.

Of course, we are unlikely to see a legislative response along these lines. Even if one could overcome the usual congressional dysfunction, the legislation I am suggesting has particularly poor optics. I am suggesting that executives receive a tax deduction for amounts repaid to their employers (or a credit for taxes previously paid) even in cases in which someone has cooked the books. This seems unlikely. Indeed, the more likely legislative response would be a move to deny deductibility when and if permitted under § 1341. It will be claimed,

inaccurately, but predictably, that such deductions represent a taxpayer subsidy for crooked executives.

As I have argued elsewhere, the disallowance of a business-related tax deduction tends to be conceptualized as the elimination of a taxpayer subsidy.¹⁸³ Despite the fact that the U.S. income tax system is based on net, not gross, income, in thinking about any particular deduction, observers tend to adopt a pre-deduction, gross income baseline, according to which deduction equals subsidy.¹⁸⁴ This tendency, I argue, is compounded by the inherent ambiguity of deductions in a net income tax system.¹⁸⁵ Some deductions *are* subsidies. These deductions extend beyond those needed to compute net income under any reasonable definition of the term. And this inherent ambiguity facilitates effective rhetoric that labels certain deductions that are needed to reach net income as taxpayer subsidies.¹⁸⁶

As an example of these pathologies, I offered the I.R.C. § 162(m) limitation on the deductibility of certain compensation paid to senior executives of public companies.¹⁸⁷ An employer must be allowed a deduction for employee compensation to reach net business income under any conception of the term, and thus deductions for compensation clearly are not subsidies.¹⁸⁸ Compensation may be excessive and ripe for regulation, but if actually paid, a deduction for compensation is appropriate in determining net income. Nonetheless, policy makers were able to exploit the tendency to frame deductions as subsidies and the ambiguity of deductions in justifying the 1993 enactment of § 162(m), with President Clinton arguing that “the Tax Code should no longer

183. David I. Walker, *Suitable for Framing: Business Deductions in a Net Income Tax System*, 52 WM. & MARY L. REV. 1247 (2011).

184. *Id.* at 1262. There are several reasons that this is the natural baseline. For one, outside of the tax context, to “deduct” generally does mean to subtract from some baseline.

185. *Id.* at 1263.

186. *Id.* at 1269.

187. *Id.* at 1268. Enacted in 1993, I.R.C. § 162(m) limited deductions by public companies for senior executive (“top five”) pay to \$1 million per executive per year with a generous exception for performance-based pay. That exception was eliminated by the TCJA. *See supra* note 55.

188. *Id.* at 1266.

subsidize excessive pay of chief executives and other high executives.”¹⁸⁹ Of course, the fact that corporate executives were and are an unpopular bunch also didn’t hurt efforts to curtail these deductions.

In the case of clawback payments, a deduction for amounts repaid or a credit for taxes previously imposed on the returned compensation simply restores the status quo ante. One would think that careful consideration of the matter would reveal that tax deductions or credits in this situation are not taxpayer subsidies for this very reason. But I am not sanguine. Tax credits sound like and generally are subsidies. Think of the Earned Income Tax Credit,¹⁹⁰ the Child Tax Credit,¹⁹¹ or various educational credits.¹⁹² These credits are all fairly characterized as subsidies delivered through the tax code. A credit for the taxes paid on returned compensation would be an exception. And even a deduction for the repaid compensation can be convincingly framed as a subsidy, just as the tax deduction for executive pay was framed as a subsidy.

Even if I am wrong about the likelihood of a legislative push to explicitly deny deductions or credits with respect to clawed back compensation, I think it extremely unlikely that Congress would enact legislation to explicitly grant such deductions or credits. In my view, the best we can realistically hope for, legislatively, is stalemate. And absent a legislative response, I would encourage the courts and the IRS to interpret § 1341 liberally to apply to all clawback payments except for cases in which executives are clearly culpable for misstated financials—for fraud, in other words. One cannot square the application of § 1341 to fraud, and one should not try, but in all other cases the courts and IRS should attempt to achieve the full tax offset ideal.

189. *Id.* at 1268 (quoting William J. Clinton, Remarks to Business Leaders (Feb. 11, 1993), *reprinted in* 1 PUBLIC PAPERS OF PRESIDENT WILLIAM J. CLINTON 85, 89 (1993)).

190. I.R.C. § 32.

191. I.R.C. § 24.

192. I.R.C. § 25A (allowing the American Opportunity Tax Credit and Lifetime Learning Credit).