The Practical Tax Mechanics of Implementing SEC Clawbacks

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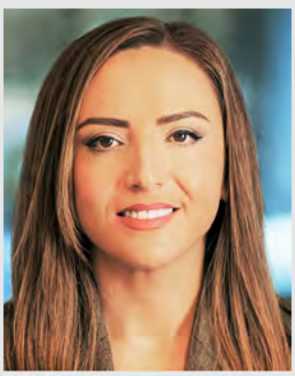

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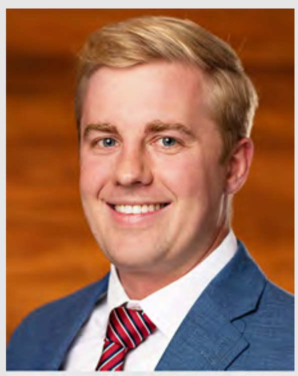

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In this article, the authors examine the SEC's new clawback rules that went into effect on December 1, 2023, and the mechanics of repaying previously paid compensation to employers.

While employer clawbacks of previously paid bonuses or other similar compensation are not particularly novel, the recently expanded SEC rules requiring public corporations to apply clawback policies in certain instances involving financial restatements will expand the scope and presumably the frequency of clawbacks. Although the notion of a compensation clawback is conceptually straightforward (the employee simply must repay amounts previously received) a repayment may raise unforeseen complexities — given that employment taxes typically have been withheld from the original payment, along with payments to employee benefit plans, which reduced compensation payments based on specific formulas applied under that plan — that must now be accounted for as part of the total repayment.

If, as expected to be most common, the repayment occurs in a tax year after the year of the original payment, the tax consequences of the repayment generally must be taken into account separately in the year of the repayment, raising additional complexities for employers. Likewise, there will be income tax consequences to the employee on the repayment, including questions about whether relief may be available under section 1341, providing more favorable tax consequences to the restoration or forfeiture of amounts previously taxed under a claim of right. As with all wage payment adjustments, especially those involving multiple years, the process can seem daunting since it may involve the interplay between different types of returns spread among several tax years. This article outlines the tax mechanics of implementing a repayment to the employer of previously paid compensation.[1]

I. Corporate Clawback Policies

Employers have often required the return of previously paid compensation when it was found not to be earned (for example, a miscalculation of a bonus) or the employee has committed a bad act (such as a violation of a nondisclosure agreement or other company policy). In practice, these situations are not particularly frequent, and in the case of an employee committing a bad act, there is often limited concern regarding the tax implications for that employee — or at that point, former employee.[2] In 2002, the Sarbanes-Oxley Act[3] introduced requirements for clawbacks that changed their scope and frequency. However, they were not viewed as particularly intrusive given the requirement of misconduct which was familiar to most affected employers and employees.

The scope of clawback requirements widened significantly with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which created a no-fault clawback regime.[4] For this purpose, the SEC might require the clawback of compensation when a financial restatement occurs regardless of whether it was the result of misconduct, and can delist a company that does not adopt and comply with the compensation recovery policy.[5] Moreover, in the case of restatements, the rules apply when there is a material error that requires restating and reissuing previously issued financial statements to reflect the correction of the error (a "big R" restatement), as well as when the error is immaterial to the prior-period financial statements but correcting the error in the current period would materially misstate the current-period financial statements (a "little r" restatement).[6] Given the breadth of the rules, the likelihood of the new policy resulting in a clawback is not remote, as one study showed that the number of financial restatements has ranged from several hundred to over 1,000 per year over the last 20 years.[7] However, the SEC rules implementing this no-fault regime were not adopted as final SEC Rule 10D-1 until October 26, 2022, and are effective only as of November 28, 2023, so no meaningful data yet exist.

Final SEC Rule 10D-1 requires a clawback of certain incentive and equity-based payments that were erroneously provided to executives.[8] Among other provisions, final Rule 10D-1 expands on Rule 10D by mandating that publicly traded corporations listed on national securities exchanges incorporate clawback provisions with enforcement mechanisms into their corporate

[1] This article is focused on the practical tax considerations of compensation clawbacks and is not intended to cover SEC and other corporate requirements. We recommend consulting with a trusted legal adviser when developing and operating clawback policies intended to comply with the SEC or other applicable requirements.

[2] *See Kraft v. United States*, 991 F.2d 292 (6th Cir. 1993).

[3] *See* William H. Donaldson, *Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002* (2003).

[4] Section 954.

[5] 17 CFR section 240.10D-1(a)(3).

[6] 17 CFR section 240.10D-1(b)(1).

[7] *See* Audit Analytics, 2021 Financial Restatements: A Twenty-One Year Review (May 2022).

[8] 17 CFR section 240.10D-1.

policies.[9] Before the required changes under the SEC rules, most corporate clawback provisions permitted enforcement at the board of directors' or management's discretion and often were not applied if the employee did not participate in any actions that resulted in the potential clawback or engage in misconduct.[10]

In contrast, under SEC Rule 10D-1, that discretion generally is removed from the employer. Also, while an impracticality exception exists, it is not based on whether the clawback is less than a threshold amount. Rather, to meet the exception, the employer must maintain records and make appropriate disclosures noting that there was an attempt to recover the erroneously paid compensation and that recovery was thereafter deemed impractical because the direct costs (such as expenses incurred to hire third parties to assist in the recovery) would exceed the amounts to be recovered.[11] Additional exceptions include an exception if recovery would violate a home-country law that was in effect when the final rules were published or if recovery would cause a tax-qualified retirement plan to fail to meet the qualification requirements.[12] All of these changes have prompted employers to update their clawback policies and assess their recordkeeping capabilities.

II. Employer Income Tax Consequences

Before venturing into the various employment tax withholding and reporting considerations for an employer receiving repayment of a bonus, we first consider the income tax consequences to the employer. Generally, a clawback of an erroneously paid amount of compensation that is recovered in the same tax year may simply be ignored without consequence.[13] However, if the bonus or other compensation was paid in a prior year, typically a corresponding compensation deduction would have been available to the employer. Under the annual method of accounting, the repayment of the bonus in a later year will not result in an amended income tax return for the year of the payment to adjust for any deduction taken. However, under the tax benefit doctrine, a taxpayer who recovers a loss must include the amount in gross income if he received a tax benefit from the loss in a prior year.[14] In this case, if the employer received the tax benefit of a deduction from the original payment of the compensation, then the employer must recognize gross income when that payment is recovered.

Some practitioners have raised the potential for the deduction to be unavailable to an accrual method taxpayer until the potential clawback period has ended, since the presumed contingency (clawback policy) may not satisfy the all-events test under the section 461 regulations.[15] This would view a bonus payment subject to a clawback policy as similar to an advance that had yet to be fully earned until the clawback was no longer available to the corporation. Most practitioners assume that this view will not prevail because a financial restatement would be considered a condition subsequent that would have to arise for a clawback to occur (rather than that a financial restatement would have to *not* occur for the employee to retain the original bonus). While the SEC rules may have broadened the scope of a potential clawback, the payment of the majority of bonuses and other compensation will hopefully not be subject to a clawback under the SEC rules, so the possibility of a clawback is remote and speculative, and the deduction may still be taken in the year of payment.[16] However, it remains to be seen how the IRS will apply the method of accounting rules and if there will be

[9] Under final SEC Rule 10D-1, employers are prohibited from insuring or indemnifying any current or former executive offer against the loss of erroneously awarded compensation. While executive officers may purchase a third-party insurance policy to fund any potential recovery obligations, special tax considerations outside the scope of this article may apply.

[10] The Ninth Circuit ruled in *SEC v. Jensen*, 835 F.3d 1100 (2016), that under section 304 of the Sarbanes-Oxley Act, the CEO and CFO were liable for repayment of bonuses and other profits regardless of personal involvement. This is now explicitly applicable to all listed public companies in accordance with the final SEC rules.

[11] 17 CFR section 240.10D-1(b)(1)(iv)(A).

[12] 17 CFR section 240.10D-1(b)(1)(iv)(B), (C).

[13] *See Couch v. Commissioner*, 1 B.T.A. 103 (1924); *Russel v. Commissioner*, 35 B.T.A. 602 (1937); and Rev. Rul. 79-311, 1979-2 C.B. 25.

[14] Section 111 and Rev. Rul. 93-75, 1993-2 C.B. 63.

[15] Reg. section 1.461-1(a)(2); and Rev. Rul. 61-127, 1961-2 C.B. 36.

[16] *See United States v. General Dynamics Corp.*, 481 U.S. 239 (1987).

fact-specific patterns under which the treatment may diverge.

A. Employment Taxes — In General

A compensation payment to an employee typically is subject to a series of employment taxes with associated withholding and reporting requirements. For purposes of this article, we will focus on two federal employment taxes — federal income tax withholding and FICA taxes.[17] The FICA tax discussion includes both the employee portion withheld from the wage payment as well as the employer portion. A clawback may also raise state income tax withholding issues, although those generally are handled similarly to federal income tax withholding issues regarding compensation payments, but the administrative process may differ depending on the state. Further, there might also be FUTA and state unemployment insurance tax considerations; although most affected employees are likely to have exceeded the applicable wage base. Thus, the discussion of state income tax, FUTA, and state unemployment insurance tax is outside the scope of this article. Employers should consider those additional issues if relevant.

To recoup the gross compensation due back to an employer in a clawback scenario, the funds generally are collected from the employee through (1) future after-tax payroll deductions, (2) an employee's personal check, or (3) an employee installment payment arrangement. The clawback policy may not specify which form the repayment will take or provide discretion to the board of directors to determine the form of repayment. The SEC rules provide flexibility for employers to determine the methods of collection.

1. Future after-tax payroll deductions.

If an employer is repaid through current compensation paid to the employee, the employer should collect the amount of the compensation clawback by deducting the amount from future remuneration (after applicable tax and other withholdings), if any, paid after the employer ascertains the clawback requirement. If that deduction from after-tax compensation is not made, the obligation of the employee to the employer for the clawback due is a matter of settlement between the employee and the employer. Depending on how long it will take for an employer to collect repayment from an employee (for example, deductions over multiple future payroll payments or collecting the lump sum from a payroll payment much later than the point of clawback), a delayed or scheduled repayment could be considered a loan, which is discussed further below.

2. Installment (re)payments.

An employer may decide to collect the clawback amount through an arrangement in which the employee repays the employer over time. However, the final SEC 10D-1 rules require that any clawback policies recover payments "reasonably promptly," in addition to fulfilling disclosure requirements under which the public company must report any attempts to collect erroneously paid compensation, including any outstanding installment agreements.[18] This raises the interesting issue of whether, for tax purposes, the repayment will be treated as a loan.[19]

On the one hand, the employer did not make the original payment as an extension of credit with the intent to be repaid the funds. On the other hand, once the clawback is required, the willingness of the employer to accept payment over time could be viewed as an extension of credit. This may particularly be true if the clawback policy or the initial board action required a lump sum repayment, and the employee and employer negotiated a repayment schedule. Federal tax issues may arise because of the potential application of section 7872, which provides that loans made to employees by their employers at interest rates below the applicable federal interest rate are considered below-market, compensation-related loans. If considered a loan, the amount representing the difference between the interest charged to the employee and the applicable federal interest rate should be included in the income of the employee on any day in

[17] *See* sections 3101-3134 and 3401-3451.

[18] 17 CFR 240.10D-1(b).

[19] This article focuses on the practical tax considerations of compensation clawbacks and is not intended to cover SEC and other corporate requirements related to loans.

which the combined amount of all outstanding loans between the employer and the employee is more than $10,000.[20]

Regardless of the loan amount and interest rate applied, the elements of a loan note detailing the terms of the loan and respective repayment should be documented. Also, if an employer forgives the debt or, for any other reason, the employee is not expected to repay the loan, the entire balance of the loan would become income subject to federal income tax withholding and wages subject to FICA tax in the year the debt is forgiven or the year in which the employer identifies that the employee will not repay the loan.

3. Requesting checks from employees.

Instead of collecting the clawback amount from the employee through future payroll deductions or installment repayments, the employer may request that the employee provide a personal check. This may be the simplest method and the only alternative for former employees but perhaps may not be the most popular with employees overall.

B. Clawback Recovered in Year of Payment

1. Employment tax adjustments.

Even if a clawback in the same year is viewed as the recovery of an erroneous payment and treated as if no payment had occurred, the clawback of a payment to which employment taxes were applied will need to reflect the recovery. The SEC rules require the recovery of the gross amount received by the individual without regard to withholdings, including federal and state income tax withholding obligations.[21] Although not entirely clear under current SEC rules, if the individual has remained employed and will receive further compensation during the year, the adjustments arguably may occur as reduced withholdings on subsequent wage payments during the year.

An employer may take the position that the reference to the "gross amount" paid to the employee does not include withheld amounts that were never credited to the employee; rather, those amounts remain unpaid if the employer retrieves those excess withholdings directly by taking corrective actions in the same calendar year. This avoids the awkward result of the employee paying the employer for withholdings made during the year only to later receive credit for those same withholdings (and presumably a refund) as part of the Form 1040 income tax process the following year. While further guidance from the SEC would clarify the result, the recovery of the withheld amounts by the employer in the same calendar year so that the employee never receives credit for them arguably means they were never "paid" to the employee (who receives no benefit from the withholdings) and avoids an unnecessary and burdensome circular flow of cash.

As noted, withholding generally may be recovered through future wage payments in the same year if the clawback occurs in the same year as the original payment and the individual is still employed. If the individual is no longer employed or the recovery occurs sufficiently late in the year that there will not be enough future wages for the remainder of the year to offset the excess withholdings on the recovered bonus, then the employer may repay the excess federal income tax (and typically state income tax) withheld and the employee portion of the FICA tax to the employee before the year-end. This should result in the Form W-2 for the year of payment and repayment reflecting the correct federal and state income tax and FICA tax withholdings based on the total wages paid during the year and reduced by the wages recovered by the employer (that is, the Form W-2 will look as if the original payment never happened).

Also, if an employer has already filed Form 941, "Employer's Quarterly Federal Tax Return," for the quarter in which the federal income tax and FICA tax were overwithheld and remitted, then the Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," should be filed for the quarter in which the overwithholding occurred to reduce the taxable wages and request a refund of the overpaid taxes. The requested refund of overpaid taxes should consist of the federal income tax and employee portion of the FICA tax refunded to the

[20] Section 7872.

[21] 17 CFR section 240.10D-1(b)(1)(iii).

employee (through either reduced withholding in future payroll periods or through a direct payment made to the employee), as well as the corresponding employer portion of the FICA tax.

Example 1: Clawback recovered in the same year (current employee) by employee's personal check.

Facts: Employee A receives a gross $300,000 bonus on January 1, 2024, from which federal and state income taxes, as well as FICA tax, were withheld and remitted, resulting in net pay of $203,297.[22] On June 1 the employer determines that a clawback of the $300,000 bonus is required. On July 1 Employee A repays the bonus to the employer via check for $203,297, and the employer recovers the $96,703 of employment tax withholdings before they are credited to the employee.

The employer must take the following steps to adjust employment tax withholding:

- *Step 1*: The employer obtains a refund from the IRS for any overpaid federal income taxes (including any applicable interest received) and the employee's portion of FICA tax. Practically, this may be accomplished in concurrence with the recovery so that any repayment amounts may be offset by potential refunds.
  - In this instance, because the repayment occurs within the same calendar year as the original payment, the employee should be obligated to repay to the employer the $203,297 in net pay.
  - The employer should obtain the remaining amount of taxes withheld and remitted (that is, $96,703) as well as the employer portion of taxes through the Form 941-X and an amended state withholding return (see Step 2 below).
  - Note that the result will be different if the clawback is recovered in a later year.
- *Step 2*: The employer amends the previously filed first-quarter 2024 federal and state employment tax returns to reduce the originally reported wages by $300,000 (by filing Form 941-X and applicable amended state employment tax forms).
  - Typically, when adjusting a prior quarter, the amount originally reported and remitted as federal and state income tax withholdings and the FICA tax (employee and employer portions) is refunded. However, an employer can choose to have the taxes credited to a future period.
- *Step 3*: Once the employer receives the credit adjustments or refunds of the federal and state income tax withholdings and the employee's portion of the FICA tax, the employer should ensure that the wages that were clawed back along with the taxes are not reported on the employee's 2024 Form W-2.
- *Potential Step 4*: There may be some unusual circumstances involving split fiscal tax years when an employer who is an accrual taxpayer filed a tax return before the recovery of the excess compensation in the same calendar year but not the same fiscal year as the employee. If the employer received the tax benefit of a deduction from the original payment of the compensation recovered in a prior fiscal year, then the employer generally must recognize gross income in the fiscal year of recovery and should determine how to reflect the income on the employer's income tax return.

2. Other benefit adjustments.

If the employee participated in any benefit plans to which contributions were made as a result of the original bonus payment, adjustments may need to be made to reflect that the employee will be repaying the gross amount of the original payment rather than the net amount. However, the consequences of those contributions under various benefit plans, such as qualified retirement plans and flexible spending accounts, are not entirely clear based on the available guidance. For example, for health or dependent care FSAs for

[22] Ordinary federal marginal income tax rates may range between 10 percent and 37 percent, depending on the individual's personal tax situation. State and local jurisdictions may impose additional taxes, depending on individual residency and where services are performed. For purposes of this example, assume the supplemental withholding tax rate of 22 percent, Social Security tax of 6.2 percent on the first $168,600 for 2024 (the year the bonus was paid), 1.45 percent Medicare tax on the full amount, the 0.9 percent additional Medicare tax on amounts exceeding $200,000, and an estimated 5 percent state income tax withholding rate on the full amount, for a total reduction of $96,703. For purposes of the examples in this article, it is assumed there are no additional wages; if there were additional wages, wage base results would need to be considered further.

which earnings do not accumulate, the consequence may simply be failing to take an additional contribution from later compensation paid in the same year as a method of truing up the previously made contribution.

For other benefit plans and compensation arrangements that are not subject to extensive regulatory requirements, such as arrangements for which annual compensation is tracked as a variable in the benefit calculation under the terms of the arrangement, employers should consider whether those plans have an established policy to deal with repayments. Employees who were not involved in the reason for the restatement may question whether they should still receive credit for the original bonus. Although only a contractual matter, to avoid misunderstandings and conflicts, it is important to review and amend plans and programs as necessary to adequately address potential clawbacks.

C. Clawbacks of Amounts Paid in Previous Years

The repayment of amounts received in previous years will be significantly more complex because, under the annual method of accounting, the employee's repayment will not be treated as a rescission of the amount originally received that can be removed from the annual federal income tax return of the year of receipt.[23] Rather, the tax consequences of the repayment will be reflected in the tax returns for the year of the repayment.

Also, federal income tax (and typically state income tax) withholding and additional Medicare tax withholding may not be adjusted after the end of the year (that is, the calendar flips from December 31 to January 1) barring the adjustment being made because of an administrative error (that is, the error being corrected is the inaccurate reporting of income tax withheld during the calendar year).[24] However, the compensation reported in Form W-2, box 1, and any excess federal income tax withheld, additional Medicare tax withheld, and typically excess state income tax withheld, for the year would continue to be reported on the Form W-2c (corrected to reflect the lower wages for FICA tax purposes) and credited toward the employee's federal (and state) personal income tax return for the year, and so could be recovered through the Form 1040 and state income tax return process.[25]

1. No netting with current compensation.

Although it may be tempting as an administratively simpler method, the repayment of an amount received in a previous year generally may not be netted with compensation to be paid in the current year — the IRS tends to view these as two separate transactions.[26] In other words, if an executive is required to repay a $300,000 bonus received in a previous year but is due a $500,000 bonus in the current year, the employer may not simply pay the employee a $200,000 bonus as a method of recovering the $300,000 bonus and treat only $200,000 as the taxable compensation amount. This would, in effect, make the $300,000 bonus repayment an above-the-line deduction.

The position that netting in this context is disallowed has not been consistently applied by either the courts or the IRS. The cases to which practitioners point for support have allowed netting for clawbacks paid in prior years when dealing with unearned advances that require subsequent adjustments.[27] Likewise, IRS guidance has allowed netting at times, but those instances tend to involve statutory or regulatory programs — such as qualified retirement plans and military pensions — with netting occurring from the same stream of payments.[28] Still, there arguably is at least some support for the position that netting is allowed in similar circumstances.

Aside from specific guidance from the courts and IRS, there also is at least some additional support to take a different position that offsetting may be allowed under general principles of accounting given that compensation paid to an employee in one year can be related to multiple years.[29] But this position is not without risk and is

[23] *Couch*, 1 B.T.A. 103; Rev. Rul. 79-311.

[24] 26 CFR section 31.6413(a)-2(c)(2).

[25] Rev. Rul. 2009-39, 2009-52 IRB 951.

[26] Rev. Rul. 79-311; AM 2009-006.

[27] *See Moorman v. Commissioner*, 26 T.C. 666 (1956); and *Drummond v. Commissioner*, 43 B.T.A. 529 (1941).

[28] *See* Rev. Rul. 2002-84, 2002-2 C.B. 953; Rev. Rul. 80-9, 1980-1 C.B. 11; Rev. Rul. 67-350, 1967-2 C.B. 58.

[29] *See, e.g., Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930).

seemingly contradictory to the position of the IRS. Also, employers are reminded that netting should not be applied to nonqualified deferred compensation given the potential risk of noncompliance under section 409A. For example, allowing the clawback to be paid through offsetting deferred amounts under a nonqualified deferred compensation plan may raise concerns regarding the potential acceleration of payments, which generally is impermissible under the section 409A rules, among other issues.[30] Applying netting to any recovered payments for tax treatment purposes should be carefully discussed with a tax adviser and properly assessed for future IRS challenges, not only for the employer but also for the affected employee (or former employee). For purposes of this article, we have assumed that no netting is allowed for repayments in years after the year of payment.

2. Employer — employment tax adjustments.

As noted, the SEC requires that the gross compensation paid in the previous year be recovered by the employer. Thus, the recovery in the current year generally will need to consider that the employee had employment taxes withheld from the previous payment. Also, federal income tax (and generally state income tax) withholding may not be amended once a calendar year ends. For federal income tax withholding in the previous year, the employee will have received credit toward his income taxes (and possibly a refund), thus no adjustment should be necessary. Similar treatment should apply to state income tax withholding but should be confirmed for each jurisdiction.

When employees have FICA tax overwithheld within a single employing entity in a calendar year, a specific process is required when requesting a refund of overpaid FICA tax. To begin the FICA tax refund process, the employer should obtain consent from the employee to request a refund on their behalf. A FICA tax refund may not be obtained without securing, or attempting to secure, employee consent. The employer should prepare a consent form in accordance with federal guidelines.[31] The affected employee should return the signed consent form to their employer, indicating that they:

1. provide consent for their employer to request a refund on their behalf; and
2. certify that they have not made previous claims for the refund and will not make any future claims for a refund of the FICA tax overpayments.

Employers are required to provide employees with at least two opportunities to consent to the refund process. Once the initial consent has been sent to the employees, the employer should provide employees with a minimum of 45 days to respond. If the first consent is returned as undeliverable or no response is received after 45 days, then a second attempt to reach an employee is required. Employers are required to provide employees with 21 days to respond to a second consent request. An employer may file for a refund of the FICA tax only after the employee consent is received or the response time has elapsed (45 to 66 days). Should the employee not respond to either consent request or have requested the refund on their personal tax return, then the employer may request only the employer portion of the FICA tax overpayment.[32] The actual request for a FICA tax refund is initiated through Form 941-X, requesting the full employer refund and the refund for employees that provided an affirmative confirmation. To request this refund, a reduction in FICA taxable wages and, subsequently, a reduction in FICA taxes should be reported on the Form 941-X for the periods in which the overpayment occurred. Once the IRS issues the FICA refund, it is the employer's responsibility to provide the employee portion of the refund to the affected employees (with applicable interest also provided by the IRS).

Further, if the employee provides consent and a refund of employee FICA tax is received from the IRS, then the employer should issue the Form W-2c, "Corrected Wage and Tax Statement," to each consenting employee. The Form W-2c should report the prior year's corrected wages as follows:

- *Form W-2c, boxes 3 and 5*: Social Security and Medicare wages should be reduced; and

[30] Reg. section 1.409A-3.

[31] Rev. Proc. 2017-28, 2017-14 IRB 1061.

[32] *Id.*

- *Form W-2c, boxes 4 and 6*: Social Security and regular Medicare taxes withheld should be reduced by the corresponding amounts. (Note: Additional Medicare tax withholding cannot be adjusted once a tax year ends.)

If consent is not received from employees, or if only the employer portion of the FICA tax refund is requested by the employer, then the Form W-2c should not be required. The employer should still file Form 941-X for the periods of overpayment, but only the employer portion of FICA tax should be requested as a refund. In that case, no refund payment should be made from the employer to employees, as no portion of the refund is considered to be the employees' portion.

Example 2: Clawback recovered in a subsequent year and employee's consent is obtained.

Facts: Employee A receives a gross $300,000 bonus on January 1, 2023, from which federal and state income taxes and FICA tax were withheld and remitted, resulting in a net payment of $203,817.[33] On June 1, 2024, the employer determines that a clawback of the $300,000 bonus is required. On July 1, 2024, Employee A repays the gross $300,000 bonus to the employer via check for $300,000. Employee A provides a completed FICA tax refund consent form.

The employer must take the following steps:

- *Step 1*: The employer obtains consent from the employee to request a refund for overpayment. Note that an employer cannot apply for a FICA tax refund without securing, or attempting to secure, employee consent.
- *Step 2*: The employer files Form 941-X to request a refund of only the overpaid FICA taxes by noting a reduction in FICA taxable wages and, subsequently, a reduction in FICA taxes on the Form 941-X for the periods in which the overpayment occurred. Note that no adjustment to federal wages or refund of federal income taxes withheld is allowed.
- *Step 3*: Once the IRS issues the FICA refund, the employer refunds the employee's portion of FICA tax (with applicable interest also provided by the IRS). Based on the example, the $9,932 in employee Social Security tax and the $4,350 in employee Medicare tax should be refunded to the employee with the applicable interest.
- *Step 4*: The employer issues the Form W-2c reporting the prior year's corrected wages as follows:
  - *Form W-2c, boxes 1 and 2*: No adjustments to wages, tips, and other compensation or federal income tax withholding;
  - *Form W-2c, boxes 3 and 5*: Social Security and Medicare wages should be reduced by $160,200 and $300,000, respectively; and
  - *Form W-2c, boxes 4 and 6*: Social Security and Medicare taxes withheld should be reduced by $9,932 and $4,350, respectively.

Example 3: Clawback recovered in a subsequent year and employee's consent is not obtained.

Facts: Employee A receives a gross $300,000 bonus on January 1, 2023, from which federal and state income taxes, as well as FICA tax, were withheld and remitted, resulting in a net payment of $203,817.[34] On June 1, 2024, the employer determines that a clawback of the $300,000 bonus is required. On July 1, 2024, Employee A repays the gross $300,000 bonus to the employer via check for $300,000. The employer does not obtain a completed FICA tax refund consent form.

The employer must take the following steps:

- *Step 1*: Because the employer did not obtain employee consent (or if only the employer portion of the FICA tax refund is requested), no Form W-2c is required. The employer files Form 941-X for the periods of overpayment, but only to obtain a refund of the employer portion of FICA tax. The

[33] For purposes of this example, assume the supplemental withholding tax rate of 22 percent, Social Security tax of 6.2 percent on the first $160,200 for 2023 (the year the bonus was paid), 1.45 percent Medicare tax on the full amount, the 0.9 percent additional Medicare tax on amounts exceeding $200,000, and an estimated 5 percent state income tax withholding rate on the full amount, for a total reduction of $96,182.

[34] For purposes of this example, assume the supplemental withholding tax rate of 22 percent, Social Security tax of 6.2 percent on the first $160,200 in 2023 (the year the bonus was paid), 1.45 percent Medicare tax on the full amount, the 0.9 percent additional Medicare tax on amounts exceeding $200,000, and an estimated 5 percent state income tax withholding rate on the full amount, for a total reduction of $96,182.

employer is under no obligation to refund the employee, as no portion of the refund from the IRS to the employer is the employee portion.

- *Step 2*: If the employer received the tax benefit of a deduction from the original payment of the compensation recovered, then the employer generally must recognize gross income in the year of recovery and should determine how to reflect the income on the employer's income tax return.
- *Step 3*: In consultation with a trusted tax adviser and to the extent available, the employee may take action to reflect the repaid amounts through Form 1040 for the year of the repayment.

3. A special note on equity compensation.

Additional consideration should be given in cases of potential clawback of equity-based arrangements. Under final SEC Rule 10D-1, the amount of repayment is defined as "the amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts," which is to be computed using reasonable estimates and without regards to taxes.[35] Also, when it comes to nonqualified deferred compensation, SEC Rule 10D-1 specifies that the executive's account balance or distributions are to be reduced by erroneously awarded compensation that was contributed to their accounts, including any accrued interest and earnings. While not all equity incentive compensation reflects nonqualified deferred compensation, employers should consider whether the recovery of any earnings (realized or unrealized) on erroneously awarded equity incentives is appropriate.

As it relates to shares such as restricted stock, restricted stock units, stock options, and stock appreciation rights, to the extent the shares are still held at the time of recovery, the final rules provide that the erroneously awarded compensation is the number of securities received exceeding the number that should have been received (or the value of that excess number). However, final SEC Rule 10D-1 does not specify how that incentive-based compensation should be recovered (that is, whether these should be returned as shares or in cash value) or how to calculate the repayment amount. Instead, the SEC notes that boards of directors should consider the statute's goal to return erroneously awarded compensation to the issuer and its shareholders, and their fiduciary duties to those shareholders in making those determinations. While it is understandable that the SEC would not want employees to retain the appreciation on the shares erroneously received, the return of the shares (or their current value at the time of the repayment) may create a mismatch between the value of the shares received when the shares were initially transferred (and so included as compensation income and wages) and the value of the shares when they are returned to the employer.

The SEC rules also provide that the issuer is required to disclose the amount of erroneously awarded compensation attributable to an accounting restatement, including an analysis of how the erroneously awarded compensation was calculated. Complicating matters further, the rules note that if incentive-based compensation is based on stock price or total shareholder return (when the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement), the amount to be recovered must be based on a reasonable estimate of the effect of the accounting restatement on the stock price or total shareholder return on which the incentive-based compensation was received, but companies should retain some discretion to calculate the value and determine the appropriate means of recovery, as this may vary by the issuer or the type of compensation arrangement.[36] Likewise, the rules do not define when the recovery must occur other than specifying that recovery should occur "reasonably promptly" without providing a definition or an example.[37] Based on this limited guidance, the outcome in many clawback situations will be interesting, particularly when it concerns the clawback of

[35] 17 CFR section 240.10D-1(b)(1)(iii).

[36] 17 CFR section 240.10D-1(b)(1).

[37] *Id.*

equity that has lost value, and future guidance from both the SEC and IRS would be helpful.

When the repayment value is less than the initial payment value (the shares have depreciated), the repayment would seem to be able to be treated as a partial clawback of only that depreciated value. When the repayment value is greater than the initial payment value (the shares have appreciated), then the treatment may depend on whether the employee has ever had a realization event for some or all of the appreciation. If there has been no realization (the shares were never sold) it would seem to be the clawback would comprise the repayment of the original value plus a forfeiture of the unrealized appreciation from the perspective of the employee. For the employer receiving the shares of employer stock, this would seem not to be an income event for the employer, but would the same hold true if the employer instead received the value of the stock and appreciation in the form of a cash payment? If there has been a realization event (the shares were previously sold), then this becomes even more complicated and will require further analysis to address the tax consequences to both the employer and the employee.

4. Employer — other consequences.

As with the same-year repayments of compensation, the employer will need to consider whether other benefit arrangements may be affected by the employee's repayment, particularly those involving the application of compensation thresholds or limits. Under the qualified plan rules, annual compensation generally is measured by box 1 of Form W-2, with certain adjustments depending on whether and which safe harbor definition is selected. Unless the employer takes the position that netting may apply, box 1 of the Form W-2 of the year of repayment will not be affected by the repayment of the bonus, so the benefit under the qualified retirement plan typically should not be affected. This same result should apply to many of the typical benefit arrangements for which compensation is reduced to pay an employer contribution, including arrangements paid for through a cafeteria plan. Note, however, that if a position of netting is taken and the repaid bonus is sufficiently large, this may result in a significantly reduced amount in box 1 of the Form W-2, if not a zero.

Still, several questions remain. Will the clawback affect any amounts earned under a supplemental executive retirement plan or that are allowed to be contributed to a nonqualified deferred compensation plan? Will any severance calculations be affected by the clawback? Clawbacks have been sufficiently rare that these situations typically have been handled after the amount has been repaid based on employment agreement terms or plan provisions that had not contemplated the possibility, but how will the new requirements affect common practice? Will the advent of the SEC clawback policies raise the need to address these consequences in advance, if for no other reason than to avoid subsequent disputes and litigation?

III. Employee — Income Tax Treatment

A. Repayment: Year of Original Payment

Under the new SEC no-fault clawbacks, the likelihood of the payment being made and the clawback process of recovery being completed in the same year are slim, but that process is nonetheless described here. If the original payment is treated as having been paid in error, then its recovery generally is far less complex since it is treated as resulting in no payment being made, similar to the treatment of a rescission.[38] Thus, no payment amount is reflected on the Form W-2 or included on the Form 1040.

B. Repayment: Year After Original Payment

While most of the tax consequences to the employer are relatively mechanical once the repayment amount has been ascertained and collected from the employee, the rules addressing the tax consequences to the employee of a repayment in a subsequent year are unclear and have been the subject of much litigation. Initially, the employee may be entitled to a deduction from the repayment of compensation. But the deduction would be a below-the-line miscellaneous itemized deduction, which is not available because the Tax Cuts and Jobs Act

[38] *See Couch*, 1 B.T.A. 103; and Rev. Rul. 79-311.

suspended all miscellaneous itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026.[39]

Even for years 2026 and beyond, a restored potential for a miscellaneous itemized deduction may not place the employee in the same position as if the original payment had never been made for a myriad of reasons, such as a decrease in the marginal tax rate or other characteristics of the current year return that make the deduction less valuable than the taxes paid for the year of the original payment. This is when the potential application of section 1341 will be critical.

IV. Section 1341

Section 1341 is intended to address amounts included in income under the claim of right doctrine[40] that are not ultimately received or retained by the taxpayer. If the amount claimed but not received exceeds $3,000, and the taxpayer is otherwise eligible, he may receive a credit in the current year intended to ensure that he is not in a worse position than if he had never included the claim of right amount in income. A credit under section 1341 may be available even though a miscellaneous itemized deduction would not be available to the taxpayer until at least 2026.

A. IRS Guidance and Related Litigation

Section 1341 relief is available if the following factors are satisfied: (1) the amount was previously included in income; (2) there is an appearance of an unrestricted right; (3) the taxpayer is entitled to the deduction in the repayment year; (4) there is liability or obligation to repay — subsequent event; and (5) the amount of deduction is greater than $3,000.[41] However, the scope of the transactions falling within this description has been a source of continued confusion and controversy given the inconsistency in how these factors have been applied in IRS guidance and court decisions, particularly regarding whether there was an appearance of an unrestricted right.

In the 1960s, the IRS issued a series of revenue rulings intended to explain the situations to which section 1341 applied (see, for example, Rev. Rul. 67-48, 1967-1 C.B. 50; Rev. Rul. 67-437, 1967-2 C.B. 296; and Rev. Rul. 68-153, 1968-1 C.B. 371). In these rulings, the IRS expressed its long-standing position that section 1341 relief generally is not available unless it is established that there was an "appearance" of an unrestricted right to the payment in the year of payment. For this purpose, whether a taxpayer had the semblance of an unrestricted right in the year of inclusion depends on all the facts available at the end of that year. Thus, section 1341 does not apply when the employee's repayment obligation was triggered by a "subsequent event" (the subsequent event test).

The IRS's interpretation and inconsistent application of the apparent right test has been strongly criticized by practitioners and at odds with some court decisions that have promulgated a different test — the same circumstances test. Under this test, section 1341 relief is available only if the recovery event arises from the same "circumstances, terms, and conditions" as the original payment.[42] While several federal circuit courts have adopted the same circumstances test, on at least one occasion, the court of federal claims has adopted the IRS position distinguishing between an apparent right and an actual right to a payment.[43] Thus, today there are arguably inconsistent revenue rulings that remain outstanding[44] while a series of court decisions questions them without providing an easily applied alternative framework.

[39] Section 67(g).

[40] According to the claim of right doctrine, any amounts received under a claim of right must be included in the employee's taxable income in the year it was received, even if it is repaid later. *See North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932); reg. section 1.451-1.

[41] Section 1341(a).

[42] *See Dominion Resources Inc. v. United States*, 219 F.3d 359, 368 (4th Cir. 2000); *Kraft*, 991 F.2d 292, and *Prince v. United States*, 610 F.2d 350 (5th Cir. 1980). *But see Nacchio v. United States*, 824 F.3d 1370, 1371 (Fed. Cir. 2016); and *Cinergy Corp. v. United States*, 55 Fed. Cl. 489 (Fed. Cl. 2003).

[43] The all circumstances test has been adopted by the Fourth, Fifth, and Sixth circuits; however, the court in *Cinergy Corp.* distinguished between an apparent right and an actual right to a payment.

[44] In a few later rulings, the IRS appears to have veered away from applying the appearance of an unrestricted right test and opted to apply a different version of the test more akin to the test applied by the Fourth, Fifth, and Sixth circuits. *See* Rev. Rul. 72-78, 1972-1 C.B. 45; and Rev. Rul. 2004-17, 2004-1 C.B. 516.

B. Section 1341 and SEC Clawbacks

The no-fault clawback policy required by the Dodd-Frank Wall Street Reform and Consumer Protection Act and recent SEC regulations is triggered by the restatement of the financial reports of a public corporation, regardless of whether the affected employee was involved in the actions resulting in the need for a restatement. Arguably, this would appear to fit into the intent of section 1341 to address income included by an employee who believed he or she had a right to the bonus — and indeed had received payment of the bonus — before later being informed that because of a restatement of the financials, the metrics of the bonus had not been met and therefore the bonus must be repaid to the employer.

The restatement of the financials does not seem to be a subsequent event unrelated to the original bonus payment. Rather, the financial statements seem to be the source of the employee's original claim of right to the bonus to which the employee was later found not to have an unrestricted right because the revised source of the bonus (the financial statements — now as amended) did not provide for the bonus originally paid. Given the potential frequency of these types of repayments, it would be helpful for the IRS to confirm this application in generally applicable published guidance (which would seem to be feasible without addressing the subsequent events test that has proven so controversial).

C. Section 1341 and Other Clawbacks

For other types of clawbacks, and in particular the types of bad-act clawbacks stemming from conduct of the employee, the viability of section 1341 (at least under the IRS guidance, if not the court decisions) is not entirely clear and will depend on the particular facts and circumstances.[45] For example, if an employee received a bonus for meeting a project metric but the same agreement required that the bonus be repaid if the employee violated a nondisclosure agreement related to the project, did the employee include the income because of the appearance of an unrestricted right later found to be restricted by the related nondisclosure provision in the same bonus arrangement? Or did the employee's violative act of disclosure constitute a separate transaction from the meeting of the project metrics that resulted in the payment of the bonus in the first place?

While much more could be written on this topic, this is one of those areas in which stating explicitly that the employee should consult his or her own tax adviser appears to be a wise approach, especially given that a position regarding the application or nonapplication of section 1341 taken by the employee will not have a consequence to the employer.

V. Conclusion

Now that the SEC's clawback policies are in effect and the implementation of clawbacks will begin, their tax consequences will need to be addressed. While the concept of recovering previously paid compensation is not new to most large employers, there will be an adjustment to the new requirements, particularly in those situations in which the recovery occurs in a tax year after the year of the original payment. There will be interesting questions for employers on the administration of policies that will have both employment tax and income tax consequences (and possibly benefit plan consequences), as well as for affected employees seeking relief under section 1341. Employers affected by the new clawback rules should be aware that the clawback process may not be as straightforward as anticipated, and they may want to consider when and whether a process should be put into place to address the required mechanics, including consideration of the tax consequences.[46] ■

[45] *See Barrett v. Commissioner*, 96 T.C. 713 (1991), *nonacq.*, AOD CC-1992-008.

[46] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.