“Computed Without Regard to Taxes Paid”: The Individual Tax Consequences of Compensation Clawbacks

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Compensation clawbacks can raise difficult, and often adverse, tax issues for employees and other service providers. Specifically, for clawbacks that are effected on a gross (pretax) basis, questions arise as to how the clawback is treated for income tax purposes and what avenues an individual may have for recovering any taxes previously paid on the recouped amount. As we describe in this client alert, the answers to these questions are far from straightforward, often counterintuitive, and largely dependent on the facts and circumstances of the original payment and its clawback. As a result, an affected individual’s likelihood of being made whole for taxes previously paid on recouped compensation will often need to be critically evaluated by a personal tax advisor.

The December 1, 2023 deadline for public companies to adopt clawback policies in accordance with Nasdaq Listing Rule 5608 or Section 303A.14 of the NYSE Listed Company Manual (Listing Rules) has focused attention on the tax implications of compensation recoupment and on the possible means of mitigating unfavorable tax results. The adoption of the Listing Rules was mandated by Rule 10D-1 of the Securities Exchange Act of 1934, as amended (Rule 10D-1). For a refresher on the key provisions of Rule 10D-1, please see our prior client alert.

While the concepts discussed in this alert generally apply to all kinds of clawbacks (including, for example, the clawback of a sign-on bonus that may be recouped if a new hire doesn’t remain employed for a specified period following the individual’s start date), in this alert we focus on the clawback of compensation under policies adopted under the new Listing Rules.

New Compensation Clawback Listing Rules

The Listing Rules adopted by the New York Stock Exchange and Nasdaq closely align with the provisions of Rule 10D-1. Under the Listing Rules, listed companies are required to adopt clawback policies mandating that—in the event such a company prepares an accounting restatement due to its material noncompliance with any financial reporting requirement under applicable securities laws—the company must recover “incentive-based compensation” that is “received” by the company’s covered executive officers during a three-year period before the accounting restatement. The Listing Rules apply on a no-fault basis, meaning even covered executives who have no responsibility for the misstated financials remain subject to having their incentive-based compensation clawed back.

Incentive-based compensation for this purpose is any compensation—whether cash or equity-based—“that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure.” This would include compensation that is granted, is earned or vests based on the satisfaction of financial performance goals tied to items such as stock price, total shareholder return, revenue, net income, operating income, profitability and EBITDA (among a host of other possible financial measures). Incentive-based compensation is considered “received” for purposes of the Listing Rules in the year during which the financial reporting measure applicable to the compensation is satisfied, even if the actual payment or grant of the incentive-based compensation to the executive occurs at a later time.

If a clawback is triggered, the amount is equal to the compensation received by the executive in excess of what would have been received had the amount of the compensation been determined on the basis of the restated financials. And, critically, the amount of the clawback must be calculated on a gross basis, without regard to any taxes paid by the covered executive in connection with the original receipt of the compensation.

Tax Implications of Clawbacks for Executives

From a federal tax perspective, the tax treatment of a clawback and the avenues an executive may have for recovering any taxes previously paid with respect to the original payment depend in large part on timing. Specifically, the analysis centers on when the compensation subject to clawback is recouped relative to the time when such compensation is included in taxable income—i.e., if the clawback occurs (1) before a tax recognition event, (2) in the same year the compensation is paid (or is otherwise taxable) or (3) in a year after the year the compensation is paid (or otherwise taxable). In this context, the definition of when incentive compensation is taxable under the Internal Revenue Code of 1986, as amended (Code) takes on particular importance because the date of taxation of incentive compensation may, and often will, differ from the date the compensation is considered received for purposes of a clawback policy. We address each of these scenarios below.

Clawback prior to tax recognition

The most straightforward scenario is when a payment is clawed back before a tax recognition event occurs. In that case, there are no tax consequences to the executive in connection with the clawback.

- Example: The tax recognition event for a stock option that is not an incentive stock option typically occurs when the stock option is exercised. If a stock option that is granted or that vests based on the achievement of a financial performance measure is clawed back before the stock option is exercised, the clawback should have no tax impact to the executive because no income was previously recognized by the executive with respect to the stock option.

Clawback in same tax year

Similarly, if a payment subject to a clawback obligation in effect at the time of the payment is clawed back in the same year that the payment was made (either through repayment by the executive or by reduction in other compensation payable later in the same year), the courts and the IRS agree that the original payment should be treated for income tax purposes as though it had never been made in the first place. The payment will be excluded from wages and gross income on the executive's Form W-2 in the applicable year, and the executive will get the benefit of any amounts withheld on the original payment in computing the executive's tax liability for the year. The employer may need to seek adjustment on IRS Form 941 to the extent any amounts were previously withheld (including for purposes of FICA) on such payment.

- Example: A restricted stock unit (RSU) granted in 2024 is subject to a performance vesting requirement based on a financial reporting measure for calendar year 2024 and also a three-year service requirement for the period of 2024–2026. The performance vesting requirement is satisfied in 2024, and after satisfaction of the service vesting requirement, the RSU is settled in cash in February 2027. The cash payment is then clawed back later in 2027 pursuant to the company's clawback policy. Even though the RSU is considered received in 2024 for purposes of the Listing Rules, for income tax purposes, it is not taxed until 2027, when the cash is received. Since the repayment of the compensation also occurs in 2027, the payment is not taxed to the executive and is not reported on the executive's Form W-2 for 2027.

An unsettled question is whether, in the context of a clawback of equity compensation settled in stock, the Listing Rules require a clawback of the specific shares associated with the compensation, or whether an executive is able to satisfy the clawback obligation on a fungible basis by disgorging other shares held by the executive. To the extent shares can be utilized on a fungible basis for purposes of a Listing Rule-clawback policy, the same-year rule may be especially useful.

- Example: In February 2024, an executive receives annual awards of (i) 1,000 performance-based shares that vest on December 31, 2024, subject to attainment of a financial reporting performance metric and (ii) 1,000 time-based shares that vest in three substantially equal installments on February 15 of each of 2025, 2026 and 2027, subject to the continued performance of services. No election under 83(b) of the Code is made with respect to any of the shares. All 1,000 performance-based shares vest on December 31, 2024. In June 2026, there is a financial restatement and it is determined that only 800 performance-based shares should have vested in 2024. If the executive is able to satisfy the clawback obligation by surrendering 200 of the 333 shares that vested in 2026 under the time-based award granted to the executive in 2024, there should be no onerous tax consequence to the executive.

Clawback in subsequent tax year

Unlike the above scenarios, the ability of an executive to recover taxes paid or otherwise achieve a tax-neutral result is significantly impaired if compensation is paid and taken into taxable income in one year and then clawed back in a later year.

(i) No Ability to Amend Prior Year's Return or to Offset Current Compensation

If an executive receives incentive-based compensation in one year and it is clawed back in a subsequent tax year, it may seem intuitive for the employer and the executive to address the associated tax consequences by amending the earlier year's Form W-2 to back out the clawed-back payment. The executive could then amend the executive's individual tax return for that year using the amended Form W-2 and thereby appropriately reflect the reduced wages and income in the year of the original payment. However, based on a string of US Supreme Court decisions dating back to 1932, it is a firm principle of federal tax law that if a clawback occurs in a year after the year of payment, neither the employer nor the executive may amend the tax return for the year in which the payment was originally made. Notably, the employer may be able to seek recovery of overpaid FICA taxes for the year of payment if a claim is made within the statute of limitations period.

Another seemingly easy fix is also unavailable to the executive. In a published ruling, the IRS takes the position that where the clawed-back amount was previously included in income in an earlier taxable year, subtracting the clawed-back amount from wages otherwise payable in the subsequent tax year in which the clawback occurs is not permitted.

(ii) Restrictions on Itemized Deduction Until 2026

Prior to 2018, an executive whose compensation had been clawed back or recouped on a gross basis could attempt to recover previously paid income taxes on the clawed-back amount by treating the repayment as an unreimbursed employee expense and taking an itemized deduction on the executive's tax return for the year of repayment. This approach had some limitations. In order to be effective, the executive's aggregate itemized deductions must have exceeded 2% of the executive's adjusted gross income (referred to as the 2% floor) and the deductions were not available with respect to the Alternative Minimum Tax (AMT). However, even this limited relief will not be available to executives until 2026 as a result of the suspension, under the Tax Cuts and Jobs Act of 2017

(TCJA), of the ability to claim miscellaneous itemized deductions such as unreimbursed employee expenses through December 31, 2025.

(iii) Uncertainty of Section 1341 and Claim of Right

In light of the incomplete relief afforded by taking an itemized deduction (even assuming such an approach becomes possible again), executives may instead look to obtain relief under Section 1341 of the Code.

Under Section 1341, an executive who repays a clawed-back amount in a year after the year of payment may, if certain requirements are met, either (1) deduct the repayment amount against the executive's taxable income for the repayment year (without regard to the 2% floor or AMT limitations in taking an itemized deduction described above) or (2) take a tax credit equal to the amount of income tax attributable to the payment in the tax year it was received—whichever method results in more favorable treatment for the executive. If the tax credit exceeds the amount of tax owed for the current year, the executive receives a refundable credit for the excess. Because Section 1341 allows a credit equal to the amount of tax paid earlier, it offers fairly complete tax relief to an executive—the amount of tax paid in the original year of payment reduces the tax payable in the year of recoupment.

On its face, Section 1341 appears to provide a promising route to favorable tax treatment for an executive whose compensation has been clawed back. However, whether any Section 1341 relief will be available to affected executives is uncertain due to the IRS's interpretation of one of that section's eligibility requirements.

To be eligible for relief under Section 1341:

- The repayment amount must exceed $3,000;
- The repayment must otherwise be deductible under another section of the Code;
- The taxpayer must have had an *apparent* unrestricted right to the repaid amount in the year that the taxpayer originally received it; and
- After the close of the tax year in which the payment was originally received, it is established that the taxpayer did not have an unrestricted right to the payment.

With regard to the second prong for Section 1341 relief, it is unclear whether amounts that would otherwise be deductible under Section 162 of the Code remain eligible for relief prior to January 1, 2026, given the suspension of miscellaneous itemized deductions under the TCJA described above. However, the crux of the uncertainty of Section 1341 relief relates to conflicting interpretations by the IRS and the courts of what it means to have an "apparent" unrestricted right to a repaid amount.

Generally, the IRS considers a right to payment to be “apparent” if it is an illusory right (rather than an actual right). For example, if an individual was contractually entitled to receive a bonus of $200,000 but, due to an administrative error, is mistakenly paid $300,000 and is required to repay the difference to the employer, the IRS would likely treat the individual as having an apparent right to the excess compensation, with Section 1341 relief potentially available. Due to the mistake, the right to the excess compensation was simply illusory. However, if the individual received the correct amount of compensation, but that compensation is later subject to repayment because the individual violates a noncompetition agreement, the IRS would likely find that the individual had an actual right to the original compensation rather than an illusory one. As a result, Section 1341 relief would not be available, as the actual right to the compensation was only defeated by an event that occurred after the payment was made.

Courts have generally taken a different view. Typically, so long as a repayment obligation arises from the same circumstances, terms and conditions as the original payment, the individual is seen as having an apparent right to the original compensation. Under this view, if the original payment is made under the expectation that certain circumstances, terms and conditions will be satisfied, and a repayment obligation arises because they are not so satisfied, Section 1341 relief is available.

It is unclear if the IRS would permit Section 1341 relief in the context of a clawback made under a policy adopted pursuant to the Listing Rules and whether the courts would agree or disagree with the IRS’s determination. An executive may argue that the “apparent” right test is satisfied because the clawed-back compensation was paid based on an expectation that the original financial statements were correct, and that expectation later turned out to be incorrect based on the need for a restatement. However, the IRS could instead treat the executive as having an actual right (and not an “apparent” right) to the compensation based on the then-current financials of the company and disallow the executive’s position that Section 1341 relief applies.

Equity Compensation

The recoupment of equity compensation under a Listing Rules-compliant clawback policy may further complicate an executive’s tax situation. In the event an equity award is subject to such a clawback, if the corresponding shares are still held by the executive, the clawback applies to the number of shares received in excess of the number that would have been received under the restated financials. For awards of restricted shares, the tax consequences of the clawback could be dependent on whether or not the executive made a timely Code Section 83(b) election with respect to the shares (although it is not common to see an 83(b) election made with respect to public company shares).

- Example: Based on the achievement of certain financial goals in 2023, an executive receives a grant of 10,000 time-based vesting restricted shares in 2024 and does not make an election under Code Section 83(b). The shares will vest on a cliff basis in 2027.

In 2025, however, in connection with a financial restatement of 2023, it is determined that the executive should have received only 7,500 shares and 2,500 shares are recouped. Because the shares are recouped prior to the time they became vested—i.e., before the time the value of the shares is required to be taken into income—the clawback should have no tax impact to the executive.

– Example: Assume the same facts, except that the executive makes a timely Code Section 83(b) election in 2024. At the time of grant, the shares have a fair market value of $100,000, which is the amount the executive takes into income in connection with the Code Section 83(b) election. At the time the 2,500 shares are recouped in 2025, presumably the executive is not entitled to a loss deduction under Code Section 83(b)(1) or to Section 1341 relief (because no deduction is otherwise permitted under the Code given Code Section 83(b)(1)) and is unable to recover any of the taxes paid on the value of the recouped shares taken into income in 2024.

Other complications can arise if recoupment occurs after the tax recognition event. The value of the shares at the time of clawback may differ substantially from the value of the shares at the time they are taken into income for federal income tax purposes under Code Section 83 (or under Code Section 421 or Section 422 in the case of the clawback of shares attributable to the exercise of options). Should gain or loss be recognized on the clawback? Is any deduction determined based on the individual’s tax basis in the shares or on their current fair market value? A “mismatch” of the prior income inclusion amount (tax basis) and value at time of clawback may occur if the executive has the ability to tender “any” shares held in satisfaction of the clawback obligation.

Different tax consequences will also ensue if the executive has sold the equity that is subject to the clawback obligation. The Listing Rules do not prescribe a specific means of implementing a clawback when the original equity is no longer held by the executive. The discretion applied by boards or their committees under their clawback policies may lead to different tax results depending on whether cash or substitute shares are required to be returned to the company.

Section 409A Issues

Special attention should also be given to the implications of Section 409A of the Code as it relates to compensation that is or may become subject to a Listing Rules-compliant clawback policy. It may be possible, for example, for executives to defer the receipt (for tax purposes) of incentive-based compensation until after the expiration of the applicable three-year look-back period to avoid the issues discussed above with respect to clawbacks effected in a year subsequent to the year of payment. Whether such an arrangement would have the desired effect would depend on the structure of the arrangement and the parties’ compliance with the strict requirements of Section 409A. It is also worth noting that using previously deferred amounts to satisfy a clawback obligation could be treated as an impermissible acceleration that subjects the executive to adverse tax consequences (including current income inclusion and an additional 20% federal tax). As a result, applying clawbacks to deferred compensation should be carefully reviewed before implementation.

Employer Considerations

Employers will also need to consider the tax consequences of implementing a clawback. As noted above, in the event a clawback occurs in the same calendar year as the payment, an employer may need to seek adjustment on IRS Form 941 to the extent of any withholding applied on the payment. In this scenario, the employer would not take a tax deduction for the clawed-back compensation. If, however, the clawback occurs in a calendar year subsequent to the year of payment, a deduction taken with respect to the original payment will presumably need to be reversed.

Conclusion

In the event a clawback occurs pursuant to a policy adopted in compliance with the Listing Rules, the tax treatment to an executive will depend on the specific facts surrounding the clawback, including the type of incentive compensation to be clawed back, the timing of the recoupment, whether the recoupment is made in cash or in shares, and the tax law in effect at the time the clawback occurs. Executives will need to consult their own tax advisors in working through these issues.

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