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Tax TARP Needed for Year One and Year Two Returns of Executive Bonus to TARP Recipient: A Case Study of Year One Rescission/Exclusion From Income and Year Two Deduction Under Section 1341

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TAX TARP NEEDED FOR YEAR ONE AND YEAR TWO
RETURNS OF EXECUTIVE BONUS TO TARP RECIPIENT:
A CASE STUDY OF YEAR ONE RESCISSION/
EXCLUSION FROM INCOME AND YEAR TWO
DEDUCTION UNDER SECTION 1341

JOHN W. LEE*

ABSTRACT

This Article addresses the tax consequences to AIG Financial employees who repay their controversial retention bonuses in the year of receipt (Year 1) or in a subsequent year (Year 2). At the time the executives received their bonuses, the media and members of Congress raised challenges that might induce such repayment, thus justifying favorable tax treatment for repaying executives. Accordingly, bonuses repaid in year 1 should be excluded from gross income under the doctrine of Year 1 rescission. Bonuses repaid in Year 2 should result in an adjustment under Section 1341, which reduces the income taxes for Year 2 by the amount that the income taxes for Year 1 would have been reduced if the repaid bonus hypothetically had been excluded from income in Year 1.

This analysis is based upon a “balancing-entry approach” which backs out a Year 1 transaction when an assumption at the time of Year 1 receipt (that the employee would get to keep the bonus) later turns out to have been in error. This balancing-entry approach is traced across a number of case law and statutory doctrines including the claim of right doctrine, the Crane-Tufts doctrine, and rescission and cancellation in Year 1. Contrary interpretations exist, however, manifesting the need for Congressional or administrative clarification so as to encourage repayments of such controversial bonuses.

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TABLE OF CONTENTS

INTRODUCTION 325

I. CASE STUDY 336

 A. *Hypotheticals* 336

 B. *Summary of Conclusions* 337

II. DOCTRINAL BRIAR-PATCH: INTO THE MAELSTROM 343

 A. *Claim of Right Doctrine* 343

 1. *Common Law* 344

 2. *Statutory Version: Section 1341* 354

 a. *Legal Fiction* 358

 b. *Rescission or Netting at Year End* 366

 i. *Evolution of Rescission and Year End Netting Cases* ... 371

 ii. *Penn Progeny* 373

 iii. *Couch Progeny* 375

 c. *Deduction vs. Voluntary Repayment* 380

CONCLUSION 388

INTRODUCTION

American Insurance Group (AIG), after receiving more than \$170 billion in taxpayer bailout money under the Treasury's Troubled Assets Relief Program¹ (TARP), paid \$165 million in "retention" bonuses to 418 executives of its Financial Products Unit on March 15, 2009.² This unit had created "the exotic derivatives that caused AIG's near-collapse and started the government rescue to avoid a global financial crisis."³ Just months earlier, in December 2008, AIG paid \$55 million in such retention bonuses.⁴

Shortly after news of the March AIG bonuses broke, Congress "shot

1. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 106, 122 Stat. 3765 (to be codified at 12 U.S.C. § 5216).

2. Martin Crutsinger, *AIG Execs Get \$165M in Bonuses; U.S. Unable to Bar Payments Despite \$170 Bil. Bailout of Troubled Insurer*, CHI. SUN-TIMES, Mar. 15, 2009, at A20. The Emergency Economic Stabilization Act provides that in certain direct Treasury purchases of troubled assets from an individual financial institution where the Treasury received a meaningful equity or debt position in the financial institution, the Treasury was to require that the financial institution meet "appropriate standards for executive compensation." § 111(b)(1) (to be codified at 12 U.S.C. § 5221). After enactment, lo and behold, the Treasury made direct investments rather than direct purchases of troubled assets. Compare Andrew Dowell & Jamie Heller, *U.S. Slates \$22 Billion for Insurers from TARP*, WALL ST. J., May 15, 2009, at A1 (discussing Treasury life insurance bailout under the capital purchase program where life insurers received funds through selling preferred stock to the government) with Greg Hitt & Deborah Solomon, *Historic Bailout Passes As Economy Slips Further*, WALL ST. J., Oct. 3, 2008, at A1 (discussing \$700 billion bailout formed prior to EESA and signed into law Oct. 4, 2008, and claiming that "[t]he Treasury Department is expected to ... start buying distressed assets") (emphasis added).

3. *Congress: Give Back AIG Bonus or Else*, STAR TRIB. (Minneapolis, MN), Mar. 18, 2009, at A1.

4. See Christopher Keating, *AIG Bonuses Actually \$218 Million; Blumenthal's Math*, HARTFORD COURANT (Conn.), Mar. 22, 2009, at A1; see also Edmund L. Andrews & Peter Baker, *Bonus Money at Troubled A.I.G. Draws Heavy Criticism*, N.Y. TIMES ONLINE, Mar. 16, 2009, http://www.nytimes.com/2009/03/16/business/16aig.html?_r=1. About \$55 million of "\$220 million in retention pay for 400 employees for 2008" was paid in December 2008, the remaining \$165 million was paid in March 2009. *Id.* According to AIG CEO Edward Liddy, the December bonuses were paid because the executives had finished closing down the types of transactions for which they were hired and left by December. *American International Group's Impact on the Global Economy: Before, During, and After the Federal Intervention: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 111th Cong. 73, 77-78, 92, 560-61 (2009) [hereinafter *House AIG Hearing*] (statement of Edward Liddy, CEO, AIG).

across the bow of the AIG executives,”⁵ sending a message—give back the bonuses or Congress would take them back one way or another.⁶ Contemporaneously, AIG CEO Edward Liddy asked the employees of AIG’s Financial Products Unit, who received retention payments in excess of \$100,000, “to step up and do the right thing” by returning at least half of those payments.⁷ Thereafter some AIG executives, under pressure from New York Attorney General Andrew Cuomo,⁸ Congress, and AIG CEO Liddy, pledged to return \$50 million of the \$165 million in AIG retention

5. 155 Cong. Rec. H4253, 4265 (daily ed. Apr. 1, 2009) (remarks of Rep. Ed Perlmutter, D-Col. who noted that consequently, “they are returning some of the money”).

6. 155 Cong. Rec. H3643, 3656 (daily ed. Mar. 19, 2009) (remarks of Charley Rangel, H. Ways & Means Chair, D-N.Y.) (“[T]his [90% tax on unreturned bonus] will be a message that will be sent in a bipartisan way.... [W]e are saying to the IRS and to the commissioner that we really want to make certain that, at the end of the day, they’re not the ones that caused the problem and then get rewarded for it.”); 155 Cong. Rec. H4253, 4267 (daily ed. Apr. 1, 2009) (remarks of Rep. Virginia Foxx, R-N.C.) (prohibiting bonuses and compensation not based on performance by TARP beneficiaries retroactive to 2008); News Release, S. Comm. on Finance, Bacus, Grassley, Wyden, Snowe Introduce The Compensation Fairness Act of 2009 (Mar. 19, 2009) *available at* <http://finance.senate.gov/press/Bpress/2009press/prb031909a.pdf> [hereinafter *News Release*] (“Compensation Fairness Act of 2009, legislation to discourage excessive compensation by companies that have taken taxpayer funds, and recoup payments made to executives at recipient institutions of funds from the Troubled Assets Relief program (TARP). For companies that received TARP funds, the legislation would impose a 35 percent excise tax on both employers and employees, on retention bonuses and other bonuses.”).

7. *House AIG Hearing*, *supra* note 4, at 54 (“The payment of large bonuses to people in the very unit that caused so much of AIG’s financial trouble does not sit well with the American taxpayer in any way, shape, or form. And for a good reason. Accordingly, this morning, I have asked the employees of AIG Financial Products to step up and do the right thing. Specifically, I have asked those who received retention payments in excess of \$100,000 or more to return at least half of those payments. Some have already stepped forward and offered to give up 100 percent of their payments.”) (statement of Edward Liddy, CEO, AIG); *see also* Mary Williams Walsh & David M. Herszenhorn, *A.I.G. Seeking Return of Half of Its Bonuses*, N.Y. TIMES, Mar. 19, 2009, at A1 (noting Mr. Liddy’s request).

8. New York State’s Attorney General announced “commitments” from nine of the top ten bonus recipients at the AIG group to give the retention bonus money back, totaling \$50 million out of the total \$165 million awarded in March 2009. Mary Williams Walsh & Carl Hulse, *A.I.G. Bonuses Of \$50 Million To Be Repaid*, N.Y. TIMES, Mar. 24, 2009, at A1; *see also* Andrew Clark, *Fear of Bonus Outrage Forces AIG Staff to Quit: 20 Employees Leave Citing Public Harassment: Workers at Mayfair Division Join Exodus*, GUARDIAN (London), Apr. 14, 2009, at 26 (“New York’s [A]ttorney [G]eneral, Andrew Cuomo, is investigating the legality of the payouts. Faced with widespread condemnation and the possibility of being publicly named, 15 of the top 20 recipients agreed to return their money.”).

bonuses paid March 15, 2009.⁹ On March 18, 2009, CEO Liddy expressly testified before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprise that, due to pressure from the above sources and public outrage, he had requested the return of all or part of bonuses just paid to executives of AIG's Financial Products Unit.¹⁰ Liddy assured various members of the Subcommittee that he would supply for the record the number of AIG executives who agreed to give back all or some of the bonuses; however, he has not done so.¹¹

Fast forward to October 22, 2009—the Treasury sent to the CEO of AIG¹² a letter containing the Special Master determination on compensation for 2009 as to senior executives and the most highly compensated employees of a TARP funded company.¹³ The letter proposed special treatment for the senior executives and most highly compensated employees of the Financial Products Unit.¹⁴ The Special Master for TARP Executive

9. Walsh & Hulse, *supra* note 8, at A1.

10. *House AIG Hearing*, *supra* note 4, at 54 (“[W]e have heard the American people loudly and clearly these past few days. The payment of large bonuses to people in the very unit that caused so much of AIG’s financial trouble does not sit well with the American taxpayer in any way, shape, or form.... The action we are taking today is a result of discussions with numerous parties, many of you [Members of Congress], including Attorney General Cuomo of New York.”) (statement of Edward Liddy, CEO, AIG); *id.* at 78 (“[I]n response to the public outrage, in response to the suggestions of many folks that I met with yesterday, just listening to the President of the United States say, we need to do something, we have attempted to amend this situation, and we have asked the people at AIG FP to demonstrate their leadership and give it back.”) (statement of Edward Liddy, CEO, AIG).

11. *Id.* at 324 (“AIG FP continues to receive responses from its employees and cannot provide a final number pending the resolution of certain tax implications and administrative details posed by return of the retention payments. Although published reports have purported to establish the amount of the retention payments committed to be returned, the final figure, in fact, has not been established. AIG is committed to providing Members of Congress with this information as soon as practicable. While AIG is disappointed with the level of resignations from AIG FP, the company is gratified by the response of many to its request to return at least a portion of the retention payments.”).

12. As of August 10, 2009, Robert Benmoshe became the CEO of AIG, superseding Edward Liddy whose post was meant to be temporary. See Liam Plevin, Joann S. Lublin & Leslie Scism, *AIG Selects Ex-Chief of MetLife As CEO: Benmoshe Will Infuse the Insurer With IPO, Deal Experience; Test of Government’s Pay*, WALL ST. J., Aug. 4, 2009, at C1, available at <http://online.wsj.com/article/SB124931167159301597.html>.

13. Letter from Kenneth R. Feinberg, Office of the Special Master TARP Executive Compensation to President and CEO of AIG, Re: Proposed Compensation Payments and Structure for Senior Executive Officers and Most Highly Compensated Employees, at 1-2, A11-12, available at <http://www.treas.gov/press/releases/docs/20091022%20AIG%20Letter.pdf> [hereinafter *Letter*].

14. Neither the Letter nor the applicable regulation, 31 C.F.R. § 30.0 (2009) (Exec-

Compensation determined that 2009 compensation for AIG's covered employees had to comport with the following standards:

1. Base salary paid in cash should not exceed \$500,000 except for good cause specifically excluding from such good cause exception any employee with existing substantial retention payment contracts.
2. The majority of base compensation should be paid in immediately vested [phantom] stock units reflecting the value of a "basket" of four AIG insurance subsidiaries, which are redeemable in three annual installments beginning two years after they are earned.¹⁵

An employee meeting objective performance metrics may be eligible for restricted stock vested only if the employee stays with AIG for three years after the grant and redeemable in 25% installments for each 25% of TARP obligations repaid.¹⁶ Employees of AIG's Financial Products Unit will receive only cash base salaries for the last two months of 2009 because their Unit contributed significantly to the deterioration of AIG's financial health.¹⁷ Financial Products Unit employees who have not repaid the entire amount of bonus pledged to be returned to AIG were limited going forward, as of November 1, 2009, to continuation of cash salaries in effect on December 31, 2008.¹⁸ This Article addresses the potential tax consequences

utive compensation and corporate governance), or the statute, Pub. L. No. 111-5, div. B tit. VII, 123 Stat. 515 (2009) (to be codified at 12 U.S.C. § 5221), define "highly compensated employee."

15. *Letter*, *supra* note 13, at 1-2.

16. *Id.* at 2.

17. *Id.* at A12. This action appears based on the factor of "employee contribution to TARP recipient value." *Id.* at A4; see 31 C.F.R. § 30.16(b)(1)(vi); see also Pub. L. No. 111-5, div. B tit. VII, 123 Stat. 516 (2009) (to be codified at 12 U.S.C. § 5221(b)(3)) ("Limits on compensation that *exclude incentives for senior executive officers of the TARP recipient to take unnecessary and excessive risks that threaten the value of such recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding.*") (emphasis added).

18. *Letter*, *supra* note 13, at A12. The regulations do not speak to such unpaid pledges. Nor does div. B tit. VII, 123 Stat. 516 (to be codified at 12 U.S.C. § 5221), but it does call for a claw back "of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees of the TARP recipient based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate." *Id.* at (b)(3)(B). This may pose a problem of statutory construction. Congress' express provision of a "claw back" of executive compensation in one provision (restatement of earnings) evidences that it did not intend a claw back in the case of failure to honor a pledge to payback bonuses. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 571-72 (1979) (finding that the important factor in determining Congressional intent and whether Congress intended to create a private right of action is whether Congress enacted express private civil remedies in other sections of the legislation at issue).

of AIG Financial Products employees who repay their bonuses.

It appears that eight covered employees were to receive no stock salary or long-term stock. Their base salaries ranged from \$100,000 to \$450,000. *Letter, supra* note 13, at E1. It also appears that five covered employees of the Financial Products Unit had made such pledges to return bonuses with four failing to honor the pledge. The remaining covered employees of this Unit have made no pledge. *Id.* at A7. In March 2009, as many as 80 Financial Products Unit employees received retention bonuses. *House AIG Hearing, supra* note 4, at 43, 71.

Mr. MANZULLO. The top 7 people at the organization received more than \$4 million in retention bonuses, and the top individual got \$6.4 million, and 73 employees got a total of \$1 million each. Were these being considered to be key players, key figures in the corporation?

Mr. LIDDY. Not within the corporation, but within the unit known as AIG FP, so just to be clear, the top people in the corporation are getting no bonuses.

Mr. MANZULLO. But that's the group that went sour, isn't it, the Financial Services Division?

Mr. LIDDY. Yes. And they would be some of the top people in AIG.

Id. at 71. At the time of the Hearing it was reported that from nine to fifteen employees had made pledges and many left. *See supra* note 8.

Only about \$19 million [of about \$50 million pledged] has been given back.... Some of the employees who had offered to return their bonuses have instead left the company, taking their cash with them. Others remain at Financial Products but are also holding on to their money until they see what Kenneth R. Feinberg ... decides about whether they should get future bonus payments they have also been promised.

Brady Dennis, *AIG Executives' Promises To Return Bonuses Have Gone Largely Unfulfilled*, WASH. POST, Dec. 23, 2009.

Feinberg had ruled that a dozen of AIG's 25 highest-paid executives would have their 2009 income slashed by 91 percent and that salaries could not exceed \$500,000 without 'good cause.' About half of the executives on this list came from AIG Financial Products, the vilified trading division that had written the disastrous credit-default swaps that brought the civilized world to the brink and forced taxpayers to extend \$182 billion (and counting) in financial support for the firm. Benmosche was deeply angry over Feinberg's decision to limit his executives' pay. But his traders were even angrier. Though the government had saved their company from imploding last September, they saw themselves as victims, scapegoats-and they were ready to fight back, departing en masse on March 16, 2010, the day after the contracts are due to be paid, if their demands [are not] met.

Gabriel Sherman, *Show Me the Money: Who Decides What a Trader is Worth*, N.Y. MAG., Nov. 30, 2009, <http://nymag.com/nes/business/62559>.

Yet, as of March 23, 2010, "nearly 85 percent [of the 104 senior executives whose pay was set by the federal pay regulator] are still with the companies even though their pay was drastically cut back" Eric Dash, *Pay Limits Caused Few to Quit Jobs*, N.Y. TIMES, Mar. 23, 2010, at B1.

On March 26, 2009, a Wall Street Journal blog¹⁹ called any AIG executive who did the “right thing”²⁰ by giving his retention bonus back to AIG in 2009 a “[s]ucker” because: (1) the repaid bonus could not be excluded from gross income because the executive was entitled to, and actually received, the bonus,²¹ an “absolute” right;²² and (2) the repayment would not be deductible²³ at all under the Alternative Minimum Tax,²⁴ thus resulting in that returned bonus, in effect, being taxed at 26, or more likely, 28%,²⁵ and still being subject to the Medicare tax.²⁶ Even a deduction for

19. James Taranto, Opinion, *Give Back That Bonus! Oh, and By the Way, You Still Owe Taxes on It*, WALL ST. J. ONLINE, Mar. 26, 2009, <http://online.wsj.com/article/SB123807922595548325.html>. This blog relied upon Richard Belzer, *The AIG Bonuses, Part 4: Return Your Bonus? Pay More in Income Taxes*, Neutral Source Blog (Mar. 25, 2009), http://www.neutralsource.org/content/blog/list_posts/month/200903/. Both of these blogs were relied upon by Catherine Rampell, *Returned Bonuses May Still Be Taxable*, N.Y. Times Economix Blog (Mar. 27, 2009), <http://economix/blogs/nytimes/com/2009/03/27/returned-bonuses-may-still-be-taxable/>.

20. See *supra* note 7.

21. Rampell, *supra* note 19. Rampell analyzed inclusion of bonuses in gross income in terms of constructive receipt. Here, the executives actually received the bonuses; the issue is whether at the time of receipt there was sufficient political opposition to the payment that inclusion in income was implicitly subject to a condition subsequent or premise that such pressure would not induce repayment, so that the right to such bonus was only apparent. *Id.*

22. To the contrary, where within the same tax year the payor and payee agree that the payee will receive a lesser amount, the payee does not have an absolute right to the greater amount. Rev. Rul. 2003-10, 2003-1 C.B. 289.

23. See *supra* note 19 (finding no authority for deducting the repayment as employee expenses in order “to avoid litigation or public disparagement”). In fact there is ample precedent that voluntary payments made to protect the taxpayer’s existing business reputation are deductible. See I.R.S. Gen. Couns. Mem. 36,560 (Jan. 21, 1976) (citing cases illustrating business reputation principle); see also *Pike v. Comm’r*, 44 T.C. 787, 799 (1965) (“[Taxpayer] paid over the money because he feared lest further controversy over the matter damage his status and reputation with the insurance industry and hence endanger his professional career, which was closely tied to that industry. We have so found. Nor do we think petitioner was unreasonable in his belief. No more is required for petitioner’s payment to Cardinal to be deductible as an ordinary and necessary business expense under section 162(a).”) (citation omitted); *Conti v. Comm’r*, 31 T.C.M. (CCH) 348, 356 (1972) (applying business reputation).

24. See I.R.C. § 56(b)(1)(A)(i) (2006) (“No deduction shall be allowed— for any miscellaneous itemized deduction.”).

25. I.R.C. § 55(b)(1)(A) (2006).

26. If a bonus returned during the same year is considered rescinded, the bonus is not subject to wage taxes. See Rev. Rul. 78-198, 1978-1 C.B. 433 (stating that if employees repay compensation within the same calendar year and the employer makes the adjustments to the federal income tax withholding, the Forms W-2 should not reflect either the wages or the withholding); see also *infra* notes 183-84.

repayment under the regular income tax would be reduced by 3% to 4% of Adjusted Gross Income (AGI) under the miscellaneous personal deduction 2% of AGI haircut²⁷ plus the reductions of itemized deductions and personal exemptions for higher income taxpayers.²⁸

The “deduction” objection pointed out by the *Wall Street Journal* Blog is accurate enough if the bonus was actually received under an “absolute” claim of right. The exclusion objection, however, does not tell the whole story. Some authorities require only a rescission and return of both parties to their position ante the bonus payment before the end of the tax year²⁹ or a

27. See I.R.C. § 67 (2006) (“miscellaneous itemized deductions allowed [when] ... the aggregate of such deductions exceeds 2 percent of [AGI]”).

28. See I.R.C. § 68 (2006) (allowable itemized deductions reduced for higher income earners).

29. See *Penn v. Robertson*, 115 F.2d 167, 171-72, 175-76 (4th Cir. 1940). In *Penn*, a corporation sold to executives in January 1931 shares of its stock at a price less than 25% of fair market value (which were held in trust with dividends to be applied to the purchase price). A shareholder derivative suit was filed almost immediately, and contemporaneously dividends of \$31,500 were credited to the taxpayer’s trust account. *Id.* at 171. On the advice of counsel, the corporation rescinded the plan before the end of the year. *Id.* In the rescission, the taxpayer’s estate returned the stock and \$31,500 in credited dividends to the corporation—all before the end of 1931. *Id.* at 176. “The whole transaction was thus consummated within the calendar year 1931 on the basis of no profit and no loss to either *Penn* or the [corporation].” *Id.* at 171. *Penn* held that the rescission in 1931, before the close of the year, “extinguished what otherwise would have been taxable income [to *Penn*] for that year.” *Id.* at 172. The shareholder derivative suits in *Penn* were analogous to the Congressional and public furor regarding the AIG bonuses.

If any bonus paid in 2008 is returned in 2009, Section 1341 should apply. See *Barrett v. Comm’r*, 96 T.C. 713 (1991), *nonacq.*, 1992-1 C.B. 1. In *Barrett*, after the SEC commenced investigation of insider trading in options by a broker, “but before the U.S. Attorney declined prosecution, two groups of specialist market maker option brokers filed civil lawsuits against the [broker-taxpayer].” *Id.* at 715. A magistrate advised settlement of the civil suits “to avoid the hazards of litigation present in a jury trial, possible subsequent appeals which could result in very substantial legal fees, and adverse trial publicity which could hurt [taxpayer’s] brokerage business.” While maintaining his innocence, broker-taxpayer settled the civil suits “by disgorging ... \$54,400 of his profit from the sale of the options. The day after the suits were settled, the SEC dropped all administrative proceedings to remove [taxpayer’s] brokerage license.” *Id.* at 715. The Tax Court held that Section 1341 applied. See *id.* at 723-24 (not allowing legal fees to be deducted). Agreeing that a “voluntary restoration” would not suffice, a conclusion that the restoration of \$54,400 was voluntarily made “without regard to any legal obligation would, in our view, be ludicrous.” *Id.* at 719. In response, the Service argued that the nexus between the year one profit and the year two repayment was not shown. *Barrett v. Comm’r*, 96 T.C. 713 (1991), *action on dec.*, 1992-008 (Mar. 23, 1992). The above summary of facts shows that the origin of the repayment was the insider trading charges and the trading itself. Thus, the deduction would be a capital loss. See *Anderson v. Comm’r*, 480 F.2d 1304, 1307 (7th Cir. 1973) (relying on *Arrowsmith v. Comm’r*, 344

year-end netting of payment of compensation and adjustment without regard to whether the bonus was received under an absolute right.³⁰ Other contrary authorities do not permit a same-year rescission or year-end netting of a payment received under an absolute right.³¹ The better, conceptually sound approach, this Article argues, is that a payment is received under only an *apparent* right, versus an absolute right, when at the time of its receipt, challenges are raised that might induce repayment.³²

Contemporary news stories, congressional hearings and floor debate manifested intense political and popular outrage at the \$165 million in AIG “retention” bonuses made in March 2009.³³ The House passed several acts

U.S. 6 (1952)). Section 1341 would apply to *Arrowsmith*. See S. REP. NO. 83-1622, at 452 (1954) (“The section will apply to cases of transferee liability such as *Arrowsmith v. Commissioner* (344 U.S. 6 (1952)).”).

30. See *McEwen v. Comm’r*, 6 T.C. 1018, 1025 (1946) (distinguishing *Stern-Slegman-Prins Co. v. Comm’r*, 79 F.2d 289 (8th Cir. 1935); *Russell v. Comm’r*, 35 B.T.A. 602 (1937); *Fulton v. Comm’r*, 11 B.T.A. 641 (1928); *Couch v. Comm’r*, 1 B.T.A. 103 (1924); I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967) (“This is evident from the ‘cash basis’ salary adjustment case of Albert W. Ressel [sic], 35 B.T.A. 602 (1937) (Acq. C.B. 1937-1, 22), wherein it was held that the corporate officer concerned had ‘actually received’ no more than a certain net amount ‘as salary’ in the taxable year at issue.”).

31. See *Crellin’s Estate v. Comm’r*, 203 F.2d 812, 814-15 (9th Cir. 1953) (“[Rescission] does not have the force and effect in [local] law of compelling the return of payments made under a dividend declaration, but which in reality is a voluntary act, [it] cannot create a deduction in any year.... [F]or tax purposes, it is that which the holding company could have compelled, not that in which the stockholders were willing to acquiesce, which controls. Otherwise, the taxpayers in this case could ‘lift the federal tax-hand’ to suit their convenience.”) (citation omitted).

32. See *infra* note 146 (Year 2 repayment); *infra* notes 190 & 216-17 and accompanying text (Year 1 repayment).

33. See *House AIG Hearings*, *supra* note 4, at 54 (“The action we are taking today [requesting a return of all or part of the March 2009 retention bonus] is a result of discussions with numerous parties, many of you, including Attorney General Cuomo of New York.”) (statement of Edward Liddy, CEO, AIG). See generally *AIG Bonus Outrage Plays Treasury Officials for Saps*, USA TODAY, Mar. 16, 2009, at 8A (“[A] ‘really upset’ Treasury Secretary ... ‘berated’ AIG’s CEO.”); Andrews & Baker, *supra* note 4 (“The bonus plan established for the financial products unit before the federal government stepped in called for \$220 million in retention pay for 400 employees for 2008. About \$55 million of that was paid in December and the remaining \$165 million was paid on Friday [March 13, 2009].”); David Cho & Brady Dennis, *Bailout King AIG Still to Pay Millions In Bonuses: Geithner Gets Firm To Make Revisions*, WASH. POST Mar. 15, 2009, at A1 (“[B]onuses and other payments have been exasperating government officials”); Stephen Foley, *Obama Fails to Halt AIG’s \$165m Bonus Payments*, THE INDEP. (London), Mar. 16, 2009, at 22 (“Politicians have reacted with fury.”); Helen Kennedy, *AN OUTRAIGE! [sic] \$450 Million in Bonuses Going to Execs Who Caused Meltdown*, N.Y. DAILY NEWS, Mar. 16, 2009, at 5 (“Lawmakers erupted in fury ... after

seeking to, in effect, claw back the bonuses.³⁴ These contemporaneous challenges support a rescission of bonuses returned by the end of 2009 and

bailed-out AIG began paying out ... bonuses”); Liam Pleven & Sudeep Reddy, *AIG Bonuses Spark Outrage; Company's 'Hands Are Tied' in \$450-Million Payout at Unit that Lost \$40.5-Billion*, GLOBE & MAIL (Canada), Mar. 16, 2009, at B5 (“public outrage grew over ... bonus payments”); E. Scott Reckard & Tom Petrino, *AIG Names Firms that Got Bailout Cash; The Disclosure, Long Sought, Doesn't Drown Out the Topic of the Day: Outrage Over Employee Bonuses*, L.A. TIMES, Mar. 16, 2009, at A1 (“[P]ublic officials expressed outrage at the giant insurer’s decision to pay \$165 million in bonuses.”).

34. The various proposals are discussed in Gary Shorter, *Congressional Research Service Report for Congress: “Say on Pay” and Other Corporate Governance Reform Initiatives*, 1-2 R4076 (Aug. 13, 2009), available at http://waxman.house.gov/UploadedFiles/Say_On_Pay_and_Other_Initiative.pdf. See also Jonathan Karl, *Payback Time? House Approves Bonus Tax; House Lawmakers Pass 90 Percent Tax on Bonuses at AIG, Bailed Out Companies*, ABC NEWS INTERNET VENTURES, Mar. 19, 2009, <http://abcnews.go.com/Business/Politics/story?id=7122719&page=1> (house votes to tax bailout money); Florence Olsen, *House Passes Legislation to Establish Executive Pay Standards for ‘Bad Actors’*, DAILY TAX REP. (BNA) No. 61, at G-9 (Apr. 2, 2009).

A bill (H.R. 1664) to curb ‘unreasonable or excessive’ executive compensation at firms that accepted federal bailout funds passed the House April 1 by 247-171 after a lengthy floor debate.

The measure would amend the Emergency Economic Stabilization Act (EESA) of 2008 (Pub. L. No. 109-280) to prohibit unreasonable and excessive compensation, and compensation not based on performance standards, at companies that receive direct capital investments of taxpayer money....

The bill would restrict the compensation of executives and employees of institutions receiving capitalization funding through EESA’s Troubled Asset Relief Program and the Housing and Economic Recovery Act of 2008, which applies to executives and employees of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and Federal Home Loan Bank.

The bill also would repeal an amendment to the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5), effectively making bonus restrictions apply to the American International Group and other recipients of TARP funds, regardless of when those companies signed bonus agreements.

Standards for compensation that is ‘unreasonable or excessive’ would be determined by the treasury secretary in consultation with and approval from federal financial regulators.

Id. A search of thomas.loc.gov on February 24, 2010 indicated that none of these bills were enacted. See Pub. L. 111-21, Section 5, 123 Stat. 1617, 1625 (2009) (establishing a Financial Crisis Inquiry Commission). The Proposed Compensation Payments of Special Master Feinberg provide an incentive for AIG Financial Products Unit employees who made pledges to return part of the March 2009 retention bonuses to honor such pledges. These rules are pursuant to the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, div. B tit. VII, 123 Stat. 516. See *supra* note 18.

hence exclusions from (1) regular taxable income, (2) alternative minimum taxable income, and (3) the taxable wage base,³⁵ as if the bonuses were never received.

Similar outrage had been voiced as to the bonuses paid in 2008:

Executives at government-rescued AIG who are taking cash perks to remain in their jobs—some as much as \$3 million—are lucky even to be employed. So says Rep. Elijah Cummings (D-Md.), who blasted AIG's decision to give retention bonuses to 130 managers while the government puts up billions for a rescue makeover....

As a condition of taking its rescue cash, Congress said AIG and other firms must curtail excessive executive pay and perks. AIG agreed to freeze bonuses and perks, but days later, AIG disclosed the retention awards. At the time of the September filing, an AIG spokesman had said the awards to its 130 managers technically aren't bonuses and don't violate the spirit of Congress' will.³⁶

Such outrage supports a Section 1341 adjustment concerning repayment in 2009.³⁷ A word to the wise, do not call it a "voluntary" repayment or "giving" the bonus back.³⁸

35. See also Rev. Rul. 75-531, 1975-2 C.B. 31, 32 (bonuses, when repaid, may be adjusted out of gross income); Rev. Rul. 66-167, 1966-1 C.B. 20 (commissions not included in gross earnings).

36. Paul Tharp, *AIG in Bonus Bungle—Pol Rips Retention Pay*, N.Y. POST, Dec. 3, 2008, at 35. See generally Christine Harper, *Main Street to Wall Street: Give Up the Bonus Checks for Good!*, STAR-LEDGER (Newark, New Jersey), Nov. 16, 2008, at B1 (noting how taxpayers want bonuses eliminated); Beth Healy, *Guidelines Urge Curbs on CEO Pay*, BOSTON GLOBE, Nov. 26, 2008, at B5 ("Yesterday, New York Attorney General Andrew Cuomo held a press conference after insurer American International Group, which is tapping \$150 billion in federal funds, agreed to eliminate bonuses and salary increases for top executives. Cuomo had called for the move. AIG said its chief executive, Edward M. Liddy, would take \$1 in base salary for 2008 and 2009."); David S. Hilzenrath, *AIG Limits Pay of Its Top Executives*, WASH. POST, Nov. 26, 2008, at D1 ("New York Attorney General Andrew M. Cuomo wrote to Liddy last week, saying it 'seems hard to imagine that AIG could pay significant bonuses or give raises to executives after the company has quite literally been bailed out by the American taxpayer.'"); Heather Landy, *Growing Sense Of Outrage Over Executive Pay*, WASH. POST, Nov. 15, 2008, at A8; Heather Landy & Lori Montgomery, *Banks Getting U.S. Aid Pressed Over Bonus Plans; N.Y. Attorney General's Letter Follows Congressional Efforts to Toughen Rules on Executive Pay*, WASH. POST, Oct. 30, 2008, at D3.

37. See *supra* note 29; see also John W. Lee & Mark S. Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. CORP. L. 137, 173-86 (1987).

38. Voluntariness of payment has been held to bar rescission and the availability of Section 1341. See *Crellin's Estate v. Comm'r*, 203 F.2d 812, 814-15 (9th Cir. 1953); I.R.S. Gen. Couns. Mem. 35,953 (Aug. 19, 1974) (treating as similar retroactive payback of salary and dividends) (considering Rev. Rul. 74-582, 1974-2 C.B. 34); I.R.S. Gen.

Since there are conflicting cases on the tax consequences and Congress has sent messages to AIG executives to encourage return of the bonuses,³⁹ in order to encourage bonus repayment and for easier tax administration, this Article argues that Congress should explicitly provide for: (1) an exclusion of any bonus from a TARP beneficiary repaid in 2009 from regular income, AMT, and taxable wage taxes; and (2) a Section 1341 adjustment for any 2009 repayments of bonuses paid in 2008 by AIG or any other TARP beneficiary. The Internal Revenue Service (the Service) should also issue a notice to the same effect. Ideally, the Service should rethink rescission within year one, year-end netting, and Section 1341 in terms of conditions subsequent and external pressure that could induce repayment. However, the urgency of quicker regulation to encourage the Congressional favored repayment of executive bonuses suggests instead that the Service should issue a ruling or notice based on administrative convenience and the public policy of not undercutting a strongly articulated Congressional policy of encouraging paybacks of bonuses paid to executives of TARP benefited companies.⁴⁰

Couns. Mem. 35,484 (Sept. 17, 1973) (proposing revocation of Rev. Rul. 69-115, 1969-1 C.B. 50 and treating as similar "voluntary" repayments of excessive salary, excessive rents, excessive royalties, and dividends); *Oswald, action on dec.*, No. 6301-66, 1968 AOD LEXIS 327, at *1 (Aug. 20, 1968) (citing *Simon, Crellin's Estate*, and *Berger*, and stating that "[t]he Service's position is that repayments of amounts received under a claim of right are not deductible where made voluntarily and not under legal obligation. Legal obligation generally means that the obligation is enforceable under applicable state law and not because the taxpayer in the exercise of his business judgment believes it to be enforceable."). The better view is that "voluntary" is a code word for no business purpose, just tax reduction. See, e.g., *Nat'l Life and Accident Ins. Co. v. United States*, 244 F. Supp. 135, 137 (M.D. Tenn. 1965) (citing *United States v. Simon*, 281 F.2d 520 (6th Cir. 1960) and *Crellin's Estate v. Comm'r*, 203 F.2d 812 (9th Cir.)), *aff'd*, 385 F.2d 832 (6th Cir. 1967); see also *Blanton v. Comm'r*, 46 T.C. 527, 530 (1966), *aff'd, per curiam*, 379 F.2d 558 (5th Cir. 1967).

39. See *supra* notes 5-6 and accompanying text.

40. Traditionally, when formulating tax policy the Service has taken into account a public policy articulated in non-tax Congressional actions so as not to frustrate such Congressional policy. See John W. Lee, Glenn Walberg & Darryl D. Whitesell, *Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It's-Worth?*, 17 VA. TAX REV. 161, 224-39 (1997). An IRS official has stated in the context of corporate rescission transactions that any restriction of the Service's liberal policy as to rescissions within the same year, provided that the parties had agreed to a contingency of rescission, would be "a further guidance policy." Amy S. Elliot, *IRS Official Explains Position on Corporate Rescissions*, 123 TAX NOTES 1406 (June 22, 2009).

I. CASE STUDY

A. *Hypotheticals*

Assume that executive A received a sizable “retention” bonus from a TARP recipient corporation, say AIG, in December 2008, and heeding the March 2009 request of its CEO to demonstrate leadership or do the right thing and “give it back,”⁴¹ A, still employed by the corporation, returned to AIG in 2009 an amount equal to some, or all, of the bonus. Assume that executive B received a similar bonus in 2008; “completed ... [his or her] work and ... [his or her responsibility] was wound down to [the corporation’s] satisfaction, ... [he or she left close] to the end of the year,”⁴² i.e., 2008, and gave back the bonus in 2009.⁴³ Assume that executive C, still employed by the corporation, received the same retention bonus in 2009 and gave it back in 2009. Also assume that executive D received the same retention bonus in 2009, left the corporation in 2009 under the same circumstances as executive B, and gave the bonus back in 2009. Further assume that all four received the retention bonus pursuant to a contract after meeting all of the contractual terms,⁴⁴ none of which required repayment of the retention bonus if certain conditions subsequent occurred.

The hypotheticals can be expanded further by assuming the executives who left before repayment in 2009 were employed in similar positions with similar duties by the end of 2009, with another employer, or were seeking such positions. Alternatively, assume that the former executive was self-employed when he or she gave back the bonus in 2009.

41. See *House AIG Hearing*, *supra* note 4, at 54, 65-66 (statement of Ed Liddy, AIG CEO).

42. See *id.* at 77-78.

43. It is possible that AIG 2009 bonuses will be repaid in 2010 given that some executives who had pledged to repay retention bonuses in 2009 had not done so by October 22, 2009. *Letter*, *supra* note 13. Such employees will be paid their cash base salary as of December 31, 2008, until such pledges are met. *Id.* at A12. Note that the requirement of payment of base compensation above a stated floor in the form of restricted stock is to apply only to post-October 2009 payments. *Id.* at 1-2. If it applied to March 2009 cash payments, rescission would not be available. *Cf.* *Comm’r v. Fender Sales, Inc.*, 338 F.2d 924, 929 (9th Cir. 1964) (“[D]ischarge by a corporation of its salary obligations to [shareholder-employees] by the issuance of the corporation’s capital stock” were payments and realization of income by the shareholder-employees.).

44. See, e.g., *House AIG Hearing*, *supra* note 4, at 72-73, 77-78, 92, 117.

B. Summary of Conclusions

What are the tax consequences to each of these executives or former executives? The only certain answer is that executives who received their retention bonus in 2008 and gave it back in 2009 are taxed in 2008 under the common law “claim of right” doctrine⁴⁵ on the amount of the retention bonus presumably subject to an up to 35% federal income tax rate⁴⁶ and 4.2% Medicare taxes. The tax treatment of repayment in 2009 of a retention bonus received in 2008, and the tax treatment of the retention bonus in 2009 given back in 2009 are murkier. This is due to a briar-patch of different doctrines and rules potentially applicable, usually with conflicting authorities under each doctrine or rule. Potential doctrines and rules include: (1) repayment in 2009 of a bonus received in 2008 under a claim of right, versus “voluntary” (hence non-deductible) repayment in 2009 of a 2008 bonus; (2) exclusion if rescission is within the same tax year; (3) year-end netting versus taxable receipt if there is an absolute right when received; (4) miscellaneous employee trade or business expenses paid in 2009 to protect the executive’s existing business reputation; and (5) for an executive who has left employment before repayment, new job expense if self-employed.

The main conflict running through this doctrinal briar-patch is between the views that: (a) taxpayers receiving payments with no preconditions or conditions subsequent cannot “‘lift the federal tax-hand’ to suit their convenience”⁴⁷ by repayment in the same tax year; nor may taxpayers deduct under a corollary to the claim of right doctrine repayments made in the next tax year, if the year one payments were made with no preconditions or conditions subsequent;⁴⁸ and (b) parties may rescind a transaction (or net with repayments) within the same tax year, thus restoring their positions status ante.⁴⁹ A more nuanced view is that where the taxpayer and the corporation are aware of external circumstances existing at the time of the year one payment which may come to induce rescission or a repayment in the same tax year or subsequent tax year, rescission is

45. Cf. Rev. Rul. 78-198, 1978-1 C.B. 433.

46. Plus exemption and itemized deductions phase-outs applicable to higher income individuals.

47. *Leicht v. Comm’r*, 137 F.2d 433, 435 (8th Cir. 1943) (holding that amounts received as salary cannot be retroactively changed during the same year by the modification of the salary agreement or by resolution of the board of directors of a corporation); accord *Crellin’s Estate v. Comm’r*, 203 F.2d 812, 815 (9th Cir. 1953).

48. See Rev. Rul. 69-115, 1969-1 C.B. 50.

49. *Couch v. Comm’r*, 1 B.T.A. 103 (1924), acq. 1925-1 C.B. 1; see also *Nat’l Life & Accident Ins. Co. v. United States*, 244 F. Supp. 135, 138 (M.D. Tenn. 1965).

permitted in the former case⁵⁰ and a Section 1341 adjustment in the latter case⁵¹ if the premise that such event will not occur proves erroneous, i.e., such condition subsequent is not fulfilled. The political and popular outrage over the payment of executive bonuses by a TARP beneficiary should be such a circumstance.⁵²

The net result is uncertainty as to tax consequences for employees of TARP recipients who return their bonuses within the same or succeeding tax year. Such uncertainty could retard repayment by employees,⁵³ which could have severe adverse political and economic consequences,⁵⁴ and could cause tax administrative difficulties for the Service as to employees or former employees who do make repayments in 2009.

50. See *infra* notes 153, 161-62 and accompanying text.

51. See *infra* notes 146, 163 and accompanying text.

52. See *supra* note 36 and *infra* note 179 and accompanying text.

53. CEO Liddy told Congress that he was unable to provide the final number of returns "pending the resolution of certain tax implications and administrative details posed by return of the retention payments." *House AIG Hearings*, *supra* note 4, at 324.

54. *Id.* at 57 (statement of Subcomm. Chair Paul Kanjorski, D-Pa.). Instead of withholding the retention bonuses, like its withholding of \$93.9 million in planned deferred compensation distributions, AIG paid the bonuses. Then, "the company hid behind legal technicalities, and the public outcry ... happened: AIG has become the subject of considerable public scorn, and the public's interest in providing ongoing, sustainable support to repair our struggling financial system has plummeted." *Id.* at 3. This sentiment was wide spread. See, e.g., 155 CONG. REC. H3643, 3646 (daily ed. Mar. 19, 2009) (statement of Rep. Carolyn Maloney, D-N.Y.) ("[I]t has become somewhat rare for the Members of this body to find themselves in virtually universal agreement, but outrage over the retention bonuses for the very members of the AIG Financial Products Division, who brought a corporate giant to its knees and the economy of our Nation to a standstill, has produced such an agreement. It would be both morally reprehensible and fiscally irresponsible for us to quietly hand over millions to those who have cost this country billions. And it is a rare cause that compels so many Members, all acting independently, to craft bills aimed at righting the same wrong"). In fact, the AIG Financial Unit employees responsible for these losses were in the part of the Unit dealing with credit default swaps. Credit default swaps are "derivative instrument[s] that provide[] insurance-like protection to investors against credit losses from the underlying obligations which were typically mortgage loans." *House AIG Hearing*, *supra* note 4, at 17 (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision (OTS)). By the time of the hearing the people dealing with credit default swaps were all gone and the retention bonuses were to be made to employees in the "derivatives book." *Id.* at 91-92, 105-06 (statements of Edward Liddy, CEO, AIG). The derivatives book also appears to involve substantial risk. *Id.* at 55-56. A Gallup poll reported that 76% of Americans wanted the AIG bonuses blocked or recovered. Lymari Morales, *Outraged Americans Want AIG Bonus Money Recovered*, Gallup Poll, (Mar. 18, 2009), available at www.gallup.com/poll/116941/Outraged-Americans-AIG-Bonus-Money-Recovered.aspx. For a taste of the outrage in the media see *supra* note 36 and *infra* note 179.

Ideally (a) any legislation enacted imposing excise taxes on employee and former employee bonuses received from a covered TARP recipient (or in part on the employee and in part on the TARP recipient), if not paid back before the end of the tax year in which the bonus is due, or (b) any amendment to the Housing and Economic Recovery Act of 2008 prohibiting unreasonable and excessive compensation and compensation not based on performance standards should address the payback tax issues exposed in this Article.

Even if no such legislation is enacted, there may have already been repayments by TARP recipient executives in 2009 of some bonuses (some paid by TARP recipients in 2008; others paid in 2009) and possibly by former TARP recipient employees who may be employed in positions with similar duties, still seeking such a position, or self-employed. Accordingly, the Service should promptly address the payback/claim of right issues for bonuses paid in 2008, and rescission or year-end netting tax issues for bonuses paid in 2009.

This Article proposes that paybacks in the year of payment be treated as an exclusion from AGI (wage taxes would reflect the income tax exclusion).⁵⁵ Truly restoring the TARP recipient and the executive to the status quo ante as tax rescission demands, conceptually would require the executive to pay to the TARP recipient, in addition to the amount of the bonus returned, an interest charge for the use of the money before return.⁵⁶ Paybacks in 2009 of bonuses paid in 2008 should give rise to a Section 1341 adjustment under the most liberal interpretation, treating the 2009 political and popular outrage calling for repayment as the non-fulfillment of the 2008 promise that such outrage would not occur in 2009.

The ideal legislative solution (by a tightly sunsetted statutory amendment or by Committee Reports so long as a statutory peg is enacted) would be for exclusion of 2008 bonuses from income in 2008 if promptly paid back in 2009. Alternatively, Congress could amend Section 1341 to provide for a year two deduction (perhaps treated as a business loss for net operating loss (NOL) purposes so that a 2009 deduction far exceeding taxable income could be carried back to offset the income reported in 2008).⁵⁷ The Service probably could not provide a 2008 exclusion from AGI for a bonus paid in that year and repaid in 2009. It could provide a

55. See *infra* notes 183-84 and accompanying text.

56. I thank one of my colleagues for this insight. A handy analog would be the interest charge under I.R.C. § 453(l)(3)(B) (2006).

57. Congress might address the wage tax problems and the phase out/hair cut of itemized deductions and personal exemptions in 2008 with a 2009 repayment. See *infra* note 184.

year two Section 1341 adjustment as discussed below. The Service could easily provide under administrative convenience an exclusion as to a covered bonus received and paid back in 2009. It could also accept a rescission in 2009 based on awareness of outside pressure at the time of payment that could predictably lead to a mutual rescission in 2009.⁵⁸

In the absence of such resolution, the majority doctrinal view is that Section 1341 would not be available to a taxpayer repaying in 2009 a bonus received in 2008 because there was no assumption that the 2008 payment might turn out in 2009 to be erroneous.⁵⁹ The minority view would allow a Section 1341 recomputation in 2009, essentially on the basis that Section 1341 was intended to be remedial.⁶⁰ Moreover, a sound conceptual basis for application of Section 1341 as to a 2009 repayment is that at the time of the payment in 2008, the TARP recipient and the executive must have assumed that opposition in 2009 would not induce a requirement of repayment (or political allies could thwart it). When that premise turned out in 2009 to be erroneous, repayment of the retention bonus would then trigger availability of Section 1341.

While there is ample precedent that a repayment in 2009 of a bonus, received in either 2008 or 2009, pursuant to an agreement entered into in 2009 after receipt of the bonus, is "voluntary," i.e., not legally required, and hence not deductible,⁶¹ the better reasoned view is that if the 2009 repayment is an ordinary and necessary expense of the employee's business in 2009, such as protecting his or her business reputation, it should be deductible in 2009.⁶² Even if this theory is accepted, such a deduction of the repayment would be subject to the 2% of AGI haircut for miscellaneous individual expenses and phase-out limitations on itemized deductions, and personal exemptions of higher-income taxpayers.⁶³ Most significantly, miscellaneous itemized deductions are specifically

58. See *Penn v. Robertson*, 115 F.2d 167, 173 (4th Cir. 1940).

59. See *infra* note 119.

60. See, e.g., *Dominion Res., Inc. v. United States*, 219 F.3d 359, 363, 369 (4th Cir. 2000) (Section 1341 meant to be remedial).

61. As discussed above at note 23 and below at notes 263 and 270-71 and accompanying text, "voluntary payments" made to protect the taxpayer-employee's existing business reputation are deductible.

62. See *Conti v. Comm'r*, 31 T.C.M. (CCH) 348 (1972) ("Clearly the fact that the payment was 'voluntarily' made does not automatically deprive petitioner of the claimed deduction."); cf. *Anderson v. Comm'r*, 56 T.C. 1370 (1971), *rev'd on other grounds*, 480 F.2d 1304 (7th Cir. 1973). This Article agrees with *Anderson*. See *infra* note 74 and accompanying text.

63. See *supra* notes 27-28 and accompanying text.

notdeductible for the Alternative Minimum Tax,⁶⁴ but Section 1341 adjustments are excluded from such terms.⁶⁵

If the employee has already left the TARP recipient corporation before repayment in 2009 and is neither employed in a similar job as an employee with similar duties at the time of the repayment or perhaps by end of first tax year repayment,⁶⁶ nor still seeking such a position, the expense might be considered non-deductible under *Welch v. Helvering*.⁶⁷ Under *Welch*, if the expense is paid in a new business of self-employment or in a new job (if the employee has different duties), it is considered a capital expenditure, that is, the cost of acquiring a new capital asset—the new business or new reputation/goodwill. Such capital expenditure should at best be amortizable over 15 years.⁶⁸ Arguably, under more modern

64. I.R.C. § 56(b)(1)(A)(i) (2006).

65. I.R.C. § 56(g)(4)(B) (2006).

66. See *United States v. Manor Care, Inc.*, 490 F. Supp. 355, 360 (D. Md. 1980) (stating that a taxpayer could deduct recurring expenses incurred during the year prior to obtaining a license and operating a business “where the expenses were incurred in the same tax year as the issuance of the license”). See generally John W. Lee, *Start-up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-on Tax Reform, and a Touch of Basics*, 6 VA. TAX REV. 1, 47-51 (1986).

67. 290 U.S. 111 (1933). Our task herein is essentially one of drawing a line between expenditures to preserve and protect business reputation and those which improve and develop good will. The Supreme Court, in deciding against the taxpayer in *Welch v. Helvering*, *supra*, recognized that

[m]any cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with borderline conclusions

We are likewise unimpressed with respondent’s attempt to characterize the payments as capital in nature because the claimed benefits would inure to petitioner beyond the taxable year. Concededly, such benefits often have an effect over a substantial period of time. But, the key question is whether such effect is the prime purpose of the payment, i.e., the creation of good will, or whether it is incidental to a primary purpose to protect and preserve an existing asset or advantage, such as we believe was the case herein. The concept of capitalization, which respondent seeks to sustain, is present in cases where current deductibility has been permitted for advertising expenditures and expenditures to improve one’s skills utilized in existing employment, even though there were indications that some general benefit would in all probability last beyond the year of expenditure.

Conti v. Comm’r, 31 T.C.M. (CCH) 348 (1972).

68. See Treas. Reg. § 1.167(a)-3(b)(1) (2009); Treas. Reg. § 1.263(a)-4(d) (2009); see also John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX REV. 273, 350-55 (2002); John Lee et al., *Restating Capitalization Standards and Rules: The*

precedents as to what constitutes a trade or business,⁶⁹ a switch from being an employee performing certain tasks and duties, to being self-employed in the same profession performing similar tasks with similar duties should not be treated as different trades or businesses. Even so, such a repayment would be subject to phase-outs for higher income individual income taxpayers, but not subject to either the limitations on miscellaneous individual expenses nor to non-deductibility for AMT purposes.

As to an executive receiving a bonus in 2009 and repaying it in 2009, Section 1341 is clearly unavailable since it requires receipt in year one and payback in year two.⁷⁰ Some very early cases (and especially their progeny) would allow exclusion of a bonus repaid within the same tax year of its receipt under the broad rule that determination of whether the taxpayer realizes compensatory income is made on a net basis at the end of the tax year.⁷¹ Other authorities reach the same result under a rescission rule if the parties are restored to the status quo ante by the end of the tax year.⁷²

There are conflicting authorities as to year-end netting and rescission doctrines. The more principled view as to both is that if there was no assumption at the time of the payment of the bonus that turns out to be incorrect at the time of the repayment, the original payment and repayment

Case for "Rough Justice" Regulations (Part Two), 23 OHIO N.U. L. REV. 1483, 1537, 1541-48 (1997); John Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One)*, 23 OHIO N.U. L. REV. 631, 711-12 (1997).

69. The critical issue is whether the business of being an employee for an old business is the same business as being self-employed in the same field using the same skills. See *Conti*, 31 T.C.M. (CCH) 348; *Jenkins v. Comm'r*, 47 T.C.M. (CCH) 238 (1983) (finding that Conway Twitty's motive in repaying Twitty Burger investors was to protect his personal business reputation since the success of country musicians is extremely dependent on their images). Wikipedia's entry on *Jenkins v. Commissioner* refers to Judge Leo Irwin's famous "Ode to Conway Twitty" and speculates that "members of the Court may have been country music aficionados as well." Wikipedia, *Jenkins v. Commissioner*, http://en.wikipedia.org/wiki/Jenkins_v._Commissioner. I can affirm that was the case, and more significantly, that Judge Irwin knew Appalachian honor, being a native of Alleghany County, North Carolina, where I went for part of grade school and high school and lived next to my Uncle Hardin Royall—a descendent of the first settler in our part of the County. Once when asked by an old-school gentleman, "whose boy are ye?" (there were no Lee's save me in that county), I replied, "My mother's oldest sister married Hardin Royall." He said, "Oh, I know the Royall's." Appalachian (Scotch-Irish) identification of in-laws with a local family appears derived from a lowland Scot folk way. See David Hackett Fischer, *ALBION'S SEED: FOUR BRITISH FOLKWAYS IN AMERICA* 665-66 (1989).

70. See I.R.C. § 1341 (2006).

71. See *infra* notes 245-46 and accompanying text.

72. See *infra* notes 229-30 and accompanying text.

do not cancel each other out and do not unwind the original payment by rescission.⁷³ Again, the view that if rescission is not legally required, the repayment in the same year is “voluntary” and non-deductible is erroneous where circumstances at the time of payment might force a rescission or repayment by year-end.⁷⁴ But such deductible repayment would be virtually worthless under the AMT non-deductibility rules discussed above.⁷⁵ If the employee has already left by the time of repayment, the same new business imbroglia would apply, but if these shoals can be avoided, the miscellaneous deduction perils are avoided as well.

Conversely, the better reasoned view is that at the time of the 2009 payment, given the substantial political and popular opposition to payment of retention bonuses, the TARP recipient and the executive must have assumed that such opposition would not be so fierce as to induce a requirement of repayment (or that political allies could thwart it). If and when that premise turns out to be erroneous in 2009, repayment of the retention bonus would trigger the rescission doctrine or year-end netting.

II. DOCTRINAL BRIAR-PATCH: INTO THE MAELSTROM

This Article first analyzes the tax treatment of return of a bonus in the year after received (year two) and then applies the underlying principles to a repayment in year one because the principles are not clearly articulated by the cases or commentators. The principles undergirding the case law claim of right year two deduction and statutory Section 1341 adjustment are relevant to repayment of a bonus in the year of receipt, particularly as to the strict interpretation of the obligation to repay in year one. Accordingly, a year two repayment of an amount received in year one under a claim of right is examined next.

A. *Claim of Right Doctrine*

It is not clear whether any of the bonuses paid to executives in December 2008 by a TARP recipient have been returned in 2009.⁷⁶ As to repayment of bonuses by AIG executives, the critical issue under both the

73. See generally David Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 871 (2008).

74. See *infra* notes 216-17, 229-38 and accompanying text.

75. See *supra* notes 24-26 and accompanying text.

76. About \$55 million of retention bonuses were paid in December 2008 to AIG Financial Products employees, but many references to 2008 bonus appear to mean a bonus received in 2009 with respect to work in 2008. See *supra* note 4 and accompanying text.

common law and statutory versions of the claim of right doctrine is the nature of the year two compulsion—whether (a) the repayment obligation must be legally enforceable; or (b) whether conditions at the time of payment must indicate the potential for adverse claims against the payment.

1. Common Law

The annual accounting principle holds that each tax year stands on its own, and a transaction usually should be closed and reported in year one even though facts may turn out different in year two.⁷⁷ Accordingly,

[e]vents in a subsequent tax year (year [two]) cannot, absent an express statutory requirement, serve to reopen a prior year (year [one]) and adjust a transaction [previously] reported in year one. This is true regardless of whether the statute of limitations has run on [the] year [one] transaction. The annual accounting principle is an administrative rule and yields to exception[] when Congress so provides.⁷⁸

Most of these exceptions operate by reopening year one⁷⁹ without regard to the statute of limitations and adjust the original transaction⁸⁰—an “‘exact’ transactional approach.”⁸¹

77. See Lee & Bader, *supra* note 37, at 171-72; see also Hasen, *supra* note 73, at 880 & n.32 (“The annual accounting principle requires the determination of income at the close of the taxable year without regard to the effect of subsequent events.”).

78. Lee & Bader, *supra* note 37, at 172.

79. *Id.* at 172-73 (citations omitted); see also *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931) (stating that, while a transactional system could be devised, Congress is not constitutionally required “to adopt such a system in preference to the more familiar method, even if it were practicable”). Later the same year the Court adopted, in effect, a partially transactional system for open transactions in *Burnet v. Logan*, 283 U.S. 404, 413-14 (1931). See generally Jeffrey M. Kilmer, Note, “Open” Transactions in Federal Income Taxation, 38 U. CIN. L. REV. 62 (1969).

80. For example,

[I]f the acquisition of a “prohibited interest” within the 10-year look-forward period occurs under a waiver of family attribution, then generally year [one] is reopened and what originally was treated as “redemption” under § 302(a) and (b) may now be a dividend. See I.R.C. § 302(c)(2) (West Supp. 1986). A tax-free § 332 liquidation of a “controlled” subsidiary by a corporate parent on a tax-free basis may take as long as three years. However, if the transaction commenced in year [one] does not produce a complete liquidation within the three-year period, year [one] is reopened and any distributions [previously] treated as distributions in complete liquidation of a controlled subsidiary are recharacterized as dividends in year [one].

Lee & Bader, *supra* note 37, at 172 n.228 (citations omitted); Treas. Reg. § 1.631-2(d)(2)

When a transaction has effects in more than one tax year, some commentators have called for transactional reporting under which year one and year two events would be taken into account in year two. The transactional reporting system adjusts for rate and bracket changes by charging an interest factor for any deferral of reporting. The “exact” transactional approach, after a false start, has not been accepted judicially⁸² but on occasion has been legislated.⁸³

The harshness of the annual accounting principle “spawned” a number of “necessary counterweights” aimed at ameliorating distortion of income when an assumption underlying the year one reporting a fundamentally inconsistent event in year two shows the year one assumption to have been erroneous.⁸⁴ Courts evolved two alternative modifications as “necessary counterweight[s] to the consequences of the annual accounting principle,”⁸⁵ aimed at minimizing distortion of income and *approximating* transactional reporting.⁸⁶

The more common alternative exceptions to the annual accounting principle provide year two adjustments when the year one transaction was closed using the best assumption possible at that time as to its ultimate outcome, but that assumption turns out in year two to have been erroneous.⁸⁷ The year two transactional balancing entry adjustment to the annual accounting principle has been perceived most clearly by judges (and commentators) in the tax benefit area, as evidenced by *Hillsboro National Bank v. Commissioner*.⁸⁸ The annual accounting system in essence provides that each tax year stands on its own. Hence, if an apparently

(2006) provides for re-characterization in year one of advance bonus royalties where the contract expires in year 2 before the timber is cut. I believe that this legislation, ignored in practice, is invalid, reopening year one.

81. Lee & Bader, *supra* note 37, at 172.

82. *Id.* at 172-73.

83. *See supra* note 80.

84. *See, e.g., Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 389 n.24 (1983) (“In situations implicating the tax benefit rule or the analogous doctrine permitting the taxpayer to take a deduction when income recognized earlier under a claim of right must be repaid ... the problem is that the taxpayer has mischaracterized some event. Either he has recognized income that eventually turns out not to be income, or he has taken a deduction that eventually turns out not to be a deduction.”).

85. *Estate of Munter v. Comm'r*, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring) (describing the true character of the tax benefit doctrine). Professor Bittker described Judge Tannenwald’s insight as a perceptive comment. Boris I. Bittker & Stephen B. Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 269 (1978).

86. *Hillsboro Nat'l Bank*, 460 U.S. at 381.

87. *Id.* at 383.

88. 460 U.S. 370 (1983).

closed transaction in year one unexpectedly reopens in a subsequent tax year (year two), an adjustment is not made to year one's return, but instead, an adjustment is made in year two. The year two adjustment does not produce exact transactional equivalence, i.e., re-opening year one or its practical equivalent, due to potential rate or bracket changes and lack of an interest factor. A year two balancing entry merely produces, in Justice O'Connor's apt words, "a less precise correction—far superior to none."⁸⁹

Under the tax benefit theory, a year one deduction which becomes known in year two to be erroneous allows for a deduction of year one state taxes and a partial state refund in year two. An income adjustment or balancing entry equal to the year two state tax refund is then made in year two to the extent the year one deduction gave rise to a federal income tax benefit. The year two adjustment is necessary to achieve a rough transactional parity with a transaction in which all events occurred in year one.⁹⁰ Justice O'Connor also noted that this same transactional equivalence underlies the year two deduction under the claim of right doctrine,⁹¹ as earlier recognized by some perceptive cases,⁹² and commentators.⁹³

Professor Boris Bittker accurately perceived such transactional equivalence and balancing entry as being the policy core of (a) the *Crane* (and hence *Tufts*) doctrine;⁹⁴ (b) the cancellation of indebtedness doctrine;⁹⁵ (c)

89. *Id.* at 380 n.11.

90. *Id.* at 383.

91. *Id.* at 377-78 n.9 & 389 n.24.

92. *See, e.g.*, *United States v. Skelly Oil Co.*, 394 U.S. 678, 686 n.5 (1969); *United States v. Rexach*, 482 F.2d 10, 23-24 (1st Cir. 1973) (tax benefit and claim of right doctrine are analogous).

93. *See, e.g.*, William T. Plumb, Jr., *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 176-79 & n.172 (1943); *see also* John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473, 505-09 (1981).

94. *Comm'r v. Tufts*, 461 U.S. 300, 309 (1983) (Commissioner "may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption."); *id.* at 312 ("[T]he mortgagor received the loan proceeds tax-free and included them in his basis on the understanding that he had an obligation to repay the full amount."); *see also* *Woodsam Assocs., Inc. v. Comm'r*, 198 F.2d 357, 359 (2d Cir. 1952); Boris I. Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, 283 (1978). When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent within the meaning of I.R.C. § 1001(b) (2006). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse

the tax benefit rule;⁹⁶ and (d) the year two deduction under the claim of right doctrine.⁹⁷ The fundamental policy is that a year two adjustment produces a clearer reflection of income than the absence of a year two balancing entry, given that year one cannot be reopened judicially or administratively (which would be the ideal rule, albeit at the cost of certainty of a filed return).

Unfortunately, the first cases that fashioned each of these rules and doctrines did not explicitly recognize the balancing entry concept; but instead, adopted different legal fictions—particularly as to income adjustments in year two.⁹⁸ The doctrines usually conflict at the margins with no

basis, and then had used the cash to satisfy his obligation to the mortgagee. Although acknowledging the tax benefit doctrine and cancellation of indebtedness balancing entry affinity with *Tufts*, Justice Blackmun distinguished the doctrines on technicalities. *Tufts*, 461 U.S. at 310 n.8 (“Although the *Crane* rule has some affinity with the tax benefit rule, the analysis we adopt is different. Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions”). The Commissioner also chose not to characterize the transaction as cancellation of indebtedness. *Id.* at 311 n.11 (“We are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here—an obligation to repay—but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation.”).

95. See generally Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of* *United States v. Kirby Lumber Co.*, 66 CAL. L. REV. 1159 (1978).

96. See *Hillsboro Nat'l Bank*, 460 U.S. at 379-80 & n.11 (citing *South Dakota Concrete Products Co. v. Comm'r*, 26 B.T.A. 1429, 1431 (1932)); Bittker & Kanner, *supra* note 85, at 270-71.

97. BORIS I. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* par. 5.7.4 (1st ed. 1981) (“Among these analogues to the tax benefit rule, the most important is probably IRC § 1341.”). I cite the 1st edition only to show Professor Bittker's early recognition of the balancing entry affinity of all of these doctrines. See also *Hillsboro Nat'l Bank*, 460 U.S. at 377 n.9, 381.

98. See *United States v. Kirby Lumber*, 284 U.S. 1, 3 (1931) (finding a cancellation of indebtedness through the freeing up of assets); *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1931) (“If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year.”); *Nat'l Bank of Commerce v. Comm'r*, 115 F.2d 875, 877 (9th Cir. 1940) (holding recovery of capital is a taxable benefit); *Crane v. Comm'r*, 331 U.S. 1, 14 (1947) (equating amount realized and economic benefit); *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (holding money refunded cannot be claimed as a deduction if not taxed when received). An excellent articulation of the problems flowing from these legal fictions is provided by *Merkel v. Comm'r*, 109 T.C. 463, 475 n.8 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999) (quoting Bittker & Thompson, *supra* note 95, at 1165):

sound policy justification flowing from the particular legal fiction originally articulated as the basis for finding (balancing entry) “income” or a (balancing entry) “deduction” in year two. Each doctrine has been codified, either in whole or in part, within the Code or the Regulations.⁹⁹

These common law tax rules all *close* year one on the best assumption possible at that time with respect to a transaction’s ultimate outcome, and if the final development of the transaction in year two proves the original assumption in year one erroneous,¹⁰⁰ the tax rules provide some type of year two “balancing entry” adjustment to cancel out the closed year one *exclusion* (the *Crane-Tufts* rule and the cancellation of indebtedness doctrine); closed year one *deduction* (the tax benefit rule and its progeny); or the closed year one *inclusion* (year two balancing entry “deduction” under the claim of right doctrine with the same character in year two under the *Arrowsmith* doctrine¹⁰¹ as the income reported in the year one closed

A particularly troublesome legacy of ... [the passage in *Kirby Lumber* that the transaction “made available \$137,521.30 assets previously offset by the obligation of bonds now extinct”] has been the tendency of some courts to read *Kirby Lumber* as holding that it is the *freeing of assets* on the cancellation of indebtedness, rather than the cancellation itself, that creates the taxable gain. Such reasoning misses the point. Income results from the discharge of indebtedness because the taxpayer received (and excluded from income) funds that he is no longer required to pay back, not because assets are freed of offsetting liabilities on the balance sheet.

99. See I.R.C. § 1245 (2006) (codifying *Crane* and requiring override of character of gain defect under amount realized fiction through partial codification of tax benefit doctrine); I.R.C. § 111 (2006) (codifying the *National Bank of Commerce* holding regarding tax benefit doctrine); I.R.C. § 108(e) (2006) (codifying the *Kirby Lumber* holding regarding cancellation of indebtedness); I.R.C. § 1341 (2006) (codifying tax treatment when money is held under a claim of right and a repayment is made in year two).

100. *Hillsboro Nat’l Bank*, 460 U.S. at 383 (“The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax ... and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous.”).

Sometimes a *subsequent event* reveals the income or deductions as reported by the taxpayer to be erroneous. Thus the unexpected recovery of a portion of an amount lost and already deducted reduces the loss as originally determined. There are even cases in which items apparently finally and accurately determined have to be adjusted *on account of a subsequent event*.

Id. at 387 n.22 (quoting H. Zysman, *Income Derived from the Recovery of Deductions*, 19 TAXES 29 (1941) (emphasis in original)).

101. *Arrowsmith v. Comm’r*, 344 U.S. 6 (1952). In *Arrowsmith*, two shareholders liquidated a closely held corporation receiving liquidating distributions in years one

transaction). In such balancing entry areas, a transaction is held open in year one only when the year one assumption is very unlikely (e.g., non-recourse acquisition liabilities in excess of fair market value or a reasonable prospect of recovery as to a casualty loss).¹⁰² An all-or-nothing open or closed approach always prevails. A risk-adjusted year one reporting is not available under these closed transaction based doctrines.¹⁰³ A year two balancing entry is necessary to more clearly reflect the taxpayer's income.

The alternative transactional exception is to hold the transaction "open" in year one and defer reporting of a gain or loss/deduction or basis until year two, when the final effect of the entire transaction is determinable.¹⁰⁴ The apparent standard for determining whether to open or close a transaction in year one is based on the probabilities of the year two event.¹⁰⁵ The reporting of the transaction in year two should retain the

through four. *Id.* at 7. The shareholders reported their gain as capital gain. *Id.* In year eight a judgment was rendered against the liquidated corporation (and hence the shareholders as transferees) and against one of the shareholders individually. *Id.* at 7-9. Each of the shareholders paid half of the judgment and deducted the payments as an ordinary business loss in year eight. *Id.* at 7. The two former shareholders of the liquidated corporation argued that their year two payment, as transferees of the liquidated corporation's previously contingent liability, was ordinary income under "the well-established principle that each taxable year is a separate unit for tax accounting purposes." *Id.* at 8. Accordingly, they reasoned there was no sale or exchange in year two so that their loss was ordinary. The Supreme Court held that the annual accounting principle was not breached by considering the liquidation transaction events in years one and two together in order to classify properly the nature of the liquidated corporation's former shareholders' payment of the liquidated corporation's contingent liability in year two. *Id.* at 9. No change was made to year one. *Id.*

102. See, e.g., *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1048 (9th Cir. 1977); cf. *Graf v. Comm'r*, 80 T.C. 944, 948 (1983); *Zappo v. Comm'r*, 81 T.C. 77, 88 (1980).

103. See *Illinois Power Co. v. Comm'r*, 792 F.2d 683, 690 (7th Cir. 1986) (Posner, J.) ("In a world without administrative costs [t]he court would merely ask what the (risk adjusted) present value of the receipt was, given the probability that it might have to be returned to the payor and the terms and conditions under which the recipient could use the money in the meantime, and the tax would be levied on that value. But this is not the method used; usually the court just asks how likely is repayment, and if the answer is, not very, the receipt is treated as income.").

104. For discussion of open transaction/deferred basis reporting as an alternative to closing a transaction in year one with balancing adjustments in year two, see Lee & Bader, *supra* note 37, at 173-86. Deferred basis reporting with constant character constitutes a transactional exception to the annual accounting principle designed to reflect the taxpayer's income more clearly. See *id.* at 173-79. Cases have not focused on open transaction year two reporting and closed transactional year one reporting, with year two transactional balancing entry as an alternative to handling contingent items.

105. See I.R.S. Gen. Couns. Mem. 35,178 (Dec. 20, 1972) ("Since the contingent stock right in this case probably was not susceptible to valuation at the time of the initial

same character that it would have had in year one had it been completed in year one.¹⁰⁶ Both gain and loss transactions can be so held open, with a statutory variant as to gain an interesting legislative history limitation on the case law.¹⁰⁷ Case law, in order to more clearly reflect income, also

exchange, and in any event was non-marketable, we think that the transaction in this case clearly would have been treated as an 'open' transaction."); I.R.S. Tech. Adv. Mem. 7301220290A (Jan. 22, 1973) (same). Compare Ari J. Brandes, *A Better Way to Understand Credit Default Swaps*, 120 TAX NOTES 235, 248 (2008) ("Analyzing whether a straddle exists further illustrates why CDSs, which generally are structured to only provide for payoff with a small probability, should be subject to open transaction treatment."), with *Merkel v. Comm'r*, 192 F.3d 844, 850 (9th Cir. 1999). In applying insolvency exception to discharge of indebtedness income, (liabilities exceed fair market value of assets), contingent liabilities are counted in the year of cancellation of any debt only if the taxpayer can "prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets." *Id.* The Tax Court below had reasoned that "[l]ogic dictates that an obligation to pay is a liability under the freeing-of-assets theory only if it can be said with a satisfactory degree of certainty that the obligation offsets assets. The critical inquiry, of course, is the *level of certainty* that is satisfactory." *Merkel v. Comm'r*, 109 T.C. 463, 475 (1997).

106. See *Dorsey v. Comm'r*, 49 T.C. 606, 628-29 & n.3 (1968); Robert J. Henry, *The Emerging Concept of Amount Realized: Results in Search of Reasons*, 51 BROOK. L. REV. 41, 69 n.141 (1984); Lee & Bader *supra* note 37, at 208; Kilmer, Note, *supra* note 79, at 66-79.

107. See H.R. REP. NO. 96-1042, at 21 (1980).

The creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted. By providing an expanded statutory installment reporting option, the Committee believes that in the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting. In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as "open" and permitting the use of the cost-recovery method sanctioned by *Burnet v. Logan*,[] 283 U.S. 404 (1931). Accordingly, it is the Committee's intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller's obligation is evidenced by a note, contractual promise, or otherwise), and that its use be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained.

Id. This committee report was interpreting an amendment to Section 453. Logan, on the other hand, was interpreting a predecessor to Section 1001, computation of amount realized. During the tax years in question in Logan the predecessor to Section 453 had not yet been enacted. It was enacted in 1926. See H.R. 1, 69th Cong. (1st Sess. 1926). "[E]xpression of opinion by a subsequent Congress on the meaning of an act adopted by an earlier Congress ha[s] little, if any, significance." *Hart v. United States*, 585 F.2d

supplies a special rule for depreciation as to annual payments of purchase price in an open transaction.¹⁰⁸ Interest is not charged on the deferred tax liability or refund under the judicial approaches.¹⁰⁹

The claim of right doctrine requires a taxpayer to report as income in year one amounts received in that year under a “claim of right.” The taxpayer in a subsequent tax year may end up repaying the amounts reported in year one.¹¹⁰ If the taxpayer must make a repayment in year two due to a fundamentally inconsistent event, articulated in this context as repayment under the rubric of “compulsion” arising out of the same circumstances, the doctrine grants the taxpayer a deduction in year two rather than reopening year one.¹¹¹ Under the year two balancing entry model, the year two repayment of an amount included in income in year

1025, 1032 (Ct. Cl. 1978); *accord* Santa Fe Pac. Gold Co. v. Comm’r, 130 T.C. 299, 314 (2008) (noting the “limited utility of using the views of a subsequent Congress to make inferences as to the intent of an earlier Congress”).

108. *Associated Patentees, Inc. v. Comm’r*, 4 T.C. 979, 985-87 (1945), *acq.*, 1959-2 C.B. 3 (holding that payments in an amount which could not be determined until a later year as the purchase price of a patent with a fixed useful life, with reasonable allowance for depreciation was equivalent to the payment made in each year sanctioning deduction for variable contingent payments); Rev. Rul. 67-136, 1967-1 C.B. 58 (agreeing to follow the *Associated Patentees* decision); *accord*, *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284 (1983); *Sarkes Tarzian, Inc. v. United States*, 159 F. Supp. 253, 268 (S.D. Ind. 1958); *Newton Insert Co. v. Comm’r*, 61 T.C. 570, 586 (1974), *aff’d per curiam*, 545 F.2d 1259 (9th Cir. 1976); *Omholt v. Comm’r*, 60 T.C. 541, 547 & n.6 (1973); *Best Lock Corp. v. Comm’r*, 31 T.C. 1217, 1234 (1959). The deduction is allowed because the annual royalty payments accurately reflect the annual cost of the patent. The total cost is recovered over the useful life of the patent. Thus, there is a minimum distortion of income. *Newton Insert Co.*, 61 T.C. at 586. See the income forecast method of depreciation under I.R.C. § 167(g) (2006), where future income can be estimated.

109. *Lee & Bader, supra* note 37, at 209.

110. *See* N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 423-24 (1932). *See generally* Harold Dubroff, *The Claim of Right Doctrine*, 40 TAX L. REV. 729, 733 (1985) (noting that the three classic elements of the year one inclusion component of the doctrine are: “(1) receipt by a taxpayer of money or other property, (2) control by the taxpayer over the utilization or disposition of money or property, and (3) assertion of some claim of right or entitlement by the taxpayer to receipt”).

111. On several occasions, the Supreme Court has barred reopening year one with respect to items repaid in year two because such reopening was violative of the annual accounting principle; any deduction of amounts received under a claim of right in year one would be allowed in the year of repayment (year two). *See* *Healy v. Comm’r*, 345 U.S. 278, 284-85 (1953); *United States v. Lewis*, 340 U.S. 590 (1951). *See generally* Dubroff, *supra* note 110, at 730-31. *Skelly Oil* explained that the refusal to reopen year one and instead allow a deduction in year two was “dictated by Congress’ adoption of an annual accounting system as an integral part of the tax code.” *United States v. Skelly Oil Co.*, 394 U.S. 678, 681 (1969). The Court also properly saw *Arrowsmith* as related to this year two balancing adjustment, i.e., supplying its character. *Id.* at 684-85.

one, pursuant to the claim of right doctrine, requires a balancing entry (i.e., a deduction) in year two in order to back out the item included in income in year one, based on the assumption that the taxpayer would not repay the item.¹¹²

The earliest authorities mostly addressed the inclusion in year one of amounts received in that year under a claim of right, and merely stated that if the amount received in year one was repaid in year two the taxpayer would be entitled to a deduction in year two.¹¹³ Later claim of right year two deduction cases turned the deductibility of the year two payment on whether the taxpayer in year two was under an obligation to repay the money. The Sixth Circuit, in *United States v. Simon*, pointed out that the “word ‘obligation’ has been interpreted both liberally and strictly by the courts.”¹¹⁴ *Simon* followed a strict construction of the term:

Taxpayers were undoubtedly motivated in entering into the agreement with the corporation to reduce the lease rentals in order to eliminate any future controversy with the Commissioner over excessive rentals. We fail to see any business purpose in making the modification agreement retroactive so as to provide for refunding of rentals already paid in a prior tax year. The sole reason, in our judgment, was to obtain a tax advantage either for the corporation, or taxpayers or both. This is not sufficient to justify the deduction claimed as payment of an “obligation” within the sense of claim of right. We agree ... that no “obligation” arises from a voluntary agreement to repay monies which

112. Cf. Dubroff, *supra* note 110, at 749, n.104 (“A reverse application of the [tax benefit] doctrine could permit deduction of repayments of items previously included in income.”). This conclusion is implicit in *Hillsboro Nat’l Bank’s* perception that the tax benefit and claim of right doctrines are “analogous.” 460 U.S. 370, 377 n.9 (1983) (“A rule analogous to the tax benefit rule protects the taxpayer who is required to report income received in one year under claim of right that he later ends up repaying. Under that rule, he is allowed a deduction in the subsequent year.”). *Hillsboro Nat’l Bank* explained that the rationale of the tax benefit rule is that when a year two event is fundamentally inconsistent with an assumption that underlies a year one deduction: “the initial accounting for the [year one] item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction [a balancing entry]—far superior to none—in the current year [two].” *Id.* at 378 n.11.

113. *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 423-24 (1932); I.R.S. Gen. Couns. Mem. 16,730, XV-1 C.B. 179, 181 (1936). On several occasions, the Supreme Court has barred reopening year one with respect to items repaid in year two because such reopening was violative of the annual accounting principle; any deduction of amounts received under a claim of right in year one would be allowed in the year of repayment (year two). See *Healy v. Comm’r*, 345 U.S. 278, 284-85 (1953); *United States v. Lewis*, 340 U.S. 590 (1951). See generally Dubroff, *supra* note 110, at 730-31.

114. *United States v. Simon*, 281 F.2d 520, 525 (6th Cir. 1960).

the taxpayer would otherwise have an absolute and unconditional right to retain.¹¹⁵

The Tax Court in *Berger v. Commissioner*¹¹⁶ considered the application of the claim of right year two deduction since the paid back compensation was below the \$3,000 floor amount that Section 1341 requires for its applicability.¹¹⁷ Following *Simon*, the Tax Court held that “there must be the obligation to repay before the claim of right doctrine can be invoked.”¹¹⁸ Analyzing local law, *Berger* found that the corporation could not have compelled in year two the officers to repay amounts of their year one compensation that the Service determined in year two to be unreasonable. Therefore, the repayment in year two was “voluntary [and] did not give rise to any deduction under the ‘claim-of-right doctrine.’”¹¹⁹ Thus, payment pursuant to an obligation that first arose in year two should not come under the deduction component of the claim of right doctrine.¹²⁰ The “compulsion” requirement boils down to a perceived obligation. This requirement may be contractual, legal, or based on a fundamental

115. *Id.* at 526.

116. 37 T.C. 1026 (1962).

117. *Id.* at 1028. The largest amount of officer compensation disallowed was \$2,400. *Id.* Section 1341 is applicable only if the amount of year two income which the taxpayer repays in year two exceeds \$3,000. I.R.C. § 1341(a)(3) (2006).

118. *Berger*, 37 T.C. at 1029.

119. *Id.* at 1031. *Berger*, approvingly quoted the above passage in the text from *Simon*. *Id.* The Tax Court in *Adams v. Commissioner*, followed *Berger* and *Simon* in applying the claim of right year two deduction. 58 T.C. 41, 53-54 (1972). The year one contract under which advance royalties were paid “specifically provided that money paid and unearned was to be returned. The return by Wyoming was not voluntary.” *Id.* at 64. I.R.S. Gen. Couns. Mem. 16,730, XV-1 C.B. 179 (1936), approved the proposition that where income received under claim of right is properly reported in income for the years in which received and subsequently paid back as required, the taxpayer is entitled to a deduction for the amount of such payment for the year in which it was paid. *See also* *Healy v. Comm’r*, 345 U.S. 278 (1953); *United States v. Lewis*, 340 U.S. 590 (1951). In applying this proposition, the following criteria must be met. First, the taxpayer must receive funds under a claim of right which are taxable in the year of receipt. *Healy*, 345 U.S. at 281-82. Second, the petitioner must show that the payee could have legally compelled the repayment: “The great weight of authority is that the payee must have at least the ability to legally compel the repayments before the repayments can be deducted by the payor.” *Berger*, 37 T.C. at 1032. Third, the taxpayer must establish that a deduction is allowable for the year of repayment. *See United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969); *Simon*, 281 F.2d at 526. Finally, the taxpayer must show that the repayment was actually made. *See Maxwell v. United States*, 334 F.2d 181, 184 (5th Cir. 1964).

120. *See Adams*, 58 T.C. at 53-54. Where the payback contract was not entered into until year two, the payback would not have arisen out of circumstances, terms and conditions of the year one payment. *Id.*

assumption existing in year one at the time of the receipt of the item to repay the amount if the year one assumption turned out in year two to be erroneous.¹²¹

The Supreme Court, in *Skelly Oil*, alluded to the issue of whether a year two deduction for a repayment of an item reported previously under the claim of right doctrine in year one arose under a specific Code provision; however, the Court did not decide whether the provision was Section 162 or Section 165.¹²² Not surprisingly, a number of subsequent decisions *incorrectly* sought to fit the year two balancing entry into the mold of a Section 162 business expense or Section 165 business loss.¹²³ Although not articulated in these terms, in *Arrowsmith*,¹²⁴ the year two capital loss (from a former shareholder's transferee liability arising from a liquidated corporation's contingent liability) was really a year two claim of right deduction of the same character as the year one "overstated" capital gain reduced in year two for the transferee liability then paid.

Although taxpayers at times have sought to deduct the repayment as an expense and there is no indication of a disinclination to allow the deduction as such, ... the deduction is generally allowed as a loss ... with the nature of the income when received determining whether the loss be capital or ordinary.¹²⁵

2. Statutory Version: Section 1341

The 1954 Internal Revenue Code introduced Section 1341, which partially affects transactional reporting. It grants a covered taxpayer a year two adjustment to taxes owed for that year for his year two "involuntary" repayment of an item when in year one "it appeared that [he] had an

121. Dubroff, *supra* note 110, at 753-55; cf. *Pennzoil-Quaker State Co. v. United States*, 511 F.3d 1365, 1375 (Fed. Cir. 2008) (Prost, J., concurring) ("I read no requirement that the item itself qualify for a deduction, but rather understand the statute to require only that the deduction be a result of a change in the taxpayer's right to the item.").

122. *Skelly Oil*, 394 U.S. at 683-84 (assuming deductibility of customer refunds as either business expense under I.R.C. § 162 or loss under § 165). This assumption overlooks the year two payments in *Arrowsmith* which, since backing out an over-reported capital gain (not reduced for the contingent transferee liability) were deductible as capital losses under § 1211. See I.R.C. § 165(f) (2006).

123. See, e.g., *Bailey v. Comm'r*, 756 F.2d 44, 46 (6th Cir. 1985) ("Before invoking § 1341, the taxpayer must be entitled under some provision of the Internal Revenue Code to a deduction for the restoration payment in that year.").

124. *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

125. *Nat'l Life and Accident Ins. Co. v. United States*, 244 F. Supp. 135, 139 (M.D. Tenn. 1965), *aff'd* 385 F.2d 832 (6th Cir. 1967) (citations omitted).

unrestricted right to such item.”¹²⁶ This adjustment is calculated at a level that is equal to the greater of his year one or year two marginal bracket and rate.¹²⁷ No interest is credited to the taxpayer from year one.¹²⁸

Statutory conditions for the application of Section 1341 are:

- (1) an item must have been included in the taxpayer’s gross income for a prior year because it appeared that the taxpayer had an unrestricted right to that item;
- (2) a deduction must be allowable for a later year because it was established after the close of the prior year that the taxpayer did not have an unrestricted right to the item;
- (3) the amount of the allowable deduction must exceed \$3,000;¹²⁹ and
- (4) the item must not arise by reason of the sale of inventory type property, other than by a regulated public utility.¹³⁰

I believe that the first two requirements were intended to codify the requirements of the common law claim of right doctrine with the added requirement that the year one payment not be illegal income—to which the taxpayer would never have an unrestricted right.

The legislative history to Section 1341 shows that Congress intended it to apply to circumstances such as those presented in *United States v. Lewis and Arrowsmith v. Commissioner*.¹³¹ *Lewis*, which involved inaccurate

126. I.R.C. § 1341(a)(1) (2006).

127. *Id.* I.R.C. § 1341 provides that the year two tax is the lesser of the tax computed with a deduction for the year two repayment or the tax for the current year computed without the deduction minus the tax savings that would have resulted if the income under the claim of right had not been included in the prior year. *Id.* One commentator criticizes the availability of using the tax rates for either the prior or current year:

[There is no] sound policy reason for providing a windfall to the chance taxpayer who finds that a deduction in the restoration year will result in greater tax savings. Rather to achieve conceptual consistency and assure fairness among taxpayers, the transaction should be viewed as a whole and the taxpayer required to adjust his prior year’s tax liability, thereby receiving as a refund or credit only that amount which he actually overpaid.

Lee & Bader, supra note 37, at 211 n.461. This commentator advocates that year one should be reopened while the model suggests instead a transactional balancing entry in year two. In *Hillsboro Nat’l Bank*, Justice O’Connor supported a year two adjustment. 460 U.S. 370, 377 (1983). In dissent, Justice Blackmun advocated reopening year one in certain circumstances. *Id.* at 425 (Blackmun, J., dissenting). See generally Dubroff, *supra* note 110, at 730-31 (discussing alternatives).

128. See John G. Corlew, Note, *Tax Benefit Rule, Claim of Right Restorations and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995, 1013 (1968).

129. See *Nat’l Life and Accident Ins. Co.*, 244 F. Supp. at 141.

130. I.R.C. § 1341(b) (2006).

131. See H.R. Rep. No. 83-1337, at A294 (1954).

computation,¹³² and *Arrowsmith*, which involved transferee liability and capital loss backed out over reported capital gain in year one,¹³³ are explainable as balancing entry cases; backing out year one erroneous assumptions with a year two loss of the same character as the year one income. In *Lewis*, the taxpayer was paid a bonus for 1944 (based on the corporate employer's pre-tax profits) which he reported on March 15, 1945.¹³⁴ In March 1945, the corporate employer filed its 1944 return reporting the same bonus as a deduction, but later, in 1945, filed an amended return claiming the bonus as a deduction in a lesser amount (based upon profits *after* taxes).¹³⁵ Sometime after the 1944 corporate tax return had been filed, the corporation discharged the taxpayer and in ensuing litigation, filed a counter-claim, claiming that the bonus should have been based on profits *after* taxes.¹³⁶ On December 3, 1946, judgment was entered in the corporation's favor, finding that

the agreement for 1944 was that the bonus should be computed on the profits after deduction for taxes and that plaintiff erroneously and mistakenly believed and understood that the bonus was to be computed before deduction of taxes, and that by virtue of this mistake plaintiff received for the year 1944 the sum of \$10,856.06 in excess of the

[If] the amount of the deduction is in excess of \$3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.... The section will apply to cases of transferee liability such as *Arrowsmith v. Commissioner* (344 U.S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

Id.; see also S. Rep. No. 83-1622, at 451 (1954) (similar); *United States v. Skelly Oil Co.*, 394 U.S. 678, 694 n.3 (1969); *Culley v. United States*, 222 F.3d 1331, 1334 (Fed. Cir. 2000) ("As an alternative to a deduction (e.g., as a capital loss) in the year of repayment, § 1341 permits certain taxpayers to reduce their taxes in the year of repayment by the amount of additional tax paid in the year of receipt due to the amount in question."). "In sum, § 1341 is designed to put the taxpayer in essentially the same position he would have been in had he never received the returned income." *Dominion Res., Inc. v. United States*, 219 F.3d 359, 363 (4th Cir. 2000).

132. *Lewis v. United States*, 91 F. Supp. 1017, 1019 (1950), *rev'd*, 340 U.S. 590 (1951).

133. *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

134. *Lewis*, 91 F. Supp. at 1017-18.

135. *Id.* at 1018-19.

136. *Id.* at 1019.

amount to which he was entitled under the agreement as found by the court.¹³⁷

In *Arrowsmith*, the shareholders of a liquidating corporation which dealt in securities received a series of liquidating distributions in 1937, 1938, 1939, and 1940.¹³⁸ In June 1939, the estate of a joint venturer with the corporation in a trading account commenced an action alleging that the corporation, in breach of its fiduciary duty, dealt on its own account with stock contributed by the joint venturer to the trading account.¹³⁹ The joint venturer obtained a judgment against the liquidated corporation and its former shareholders as transferees in March 1942, which was affirmed on August 1, 1944.¹⁴⁰

The above chronologies of *Lewis* and *Arrowsmith* show that at the end of year one, no claim had been lodged disputing the amount reported in year one—which the Service implies is a prerequisite for application of Section 1341.¹⁴¹ The correct approach is whether the year two establishment of the lack of an unrestricted right to the income *arises* “out of the circumstances, terms and conditions of the original payment of such item to the taxpayer.”¹⁴² The clearest example is *Pahl v. Commissioner*, where the taxpayer was allowed a Section 1341 year two adjustment for repayment to his corporate employer of the “unreasonable” portion of compensation paid *after* execution of a contract obligating him to make such repayments upon a determination by the Service of such unreasonableness.¹⁴³ However, *Pahl* was denied a Section 1341 adjustment for year two repayments of the amount of “unreasonable” compensation paid to him *before* execution of such contract (which had a retroactive feature covering pre-execution payments to the employee).¹⁴⁴ Thus, the better

137. *Id.*

138. *Arrowsmith*, 344 U.S. at 7.

139. *Id.*

140. *Id.*

141. The question of whether an *actual* claim of right can qualify as an *apparent* one under the statute has caused some disagreement in the federal courts. Compare *Dominion Res.*, 219 F.3d 359 (holding that a taxpayer may qualify for Section 1341 treatment even if, during the year of receipt, he did in fact have an actual right to the item of income), with *Cinergy Corp. v. United States*, 55 Fed. Cl. 489, 505 (2003) (holding that Section 1341 treatment presupposes that the taxpayer’s right to was “apparent,” not “actual,” in the year of receipt), and *Alcoa, Inc. v. United States*, 509 F.3d 173, 178 n.5 (3d Cir. 2007).

142. *Dominion Res.*, 219 F.3d at 367 (quoting *Pahl v. Comm’r*, 67 T.C. 286, 290 (1976)).

143. 67 T.C. at 289-91.

144. *Id.*

view is that Section 1341 applies to: (1) implicit contingencies present in year one, including a beneficiary's year two repayment to a trust, under a year two court order of excessive year one distributions of trust income due to a miscalculation undercounting trust expenses;¹⁴⁵ (2) (critically in the context of a year two repayment by AIG executives of a year one bonus) a year two disgorgement of year one insider trading profits in settlement of a Securities and Exchange Commission proceeding;¹⁴⁶ and, (3) year two restoration to customers by public utility of rate overcharges arising from year one charges reflecting projected liability for federal corporate income taxes at the 46% rate when the rate was reduced to 34%.¹⁴⁷

a. Legal Fiction

The legal fiction under the case law and statutory claim of right doctrine¹⁴⁸ is basing the year two deduction on an explicit Code section, viz., Section 162 or 165.¹⁴⁹ I believe that the year two deduction is an extra-Code deduction that is made to cancel out the item reported as income in year one in order to more clearly reflect income. This legal fiction as to year two deductions under the claim of right doctrine is most starkly revealed by the line of modern cases considering paybacks of un-

145. *Prince v. United States*, 610 F.2d 350, 352 (5th Cir. 1980).

146. *See supra* note 29 discussing facts of *Barrett v. Comm'r*. While the Service argues the nexus between the year one payment and year two repayment was not shown, see I.R.S. *action on dec.* 1992-08 (Apr. 6, 1992). The facts in note 29 *supra* show that this is also ludicrous.

147. *Dominion Res.*, 219 F.3d at 364.

148. *See Lee & Bader, supra* note 37, at 210 ("The claim of right doctrine requires a taxpayer to report as income in year [one] amounts received in that year under a 'claim of right.' The taxpayer later may end up repaying the amounts reported in year [one]."). The three classic elements of the year one inclusion component of the doctrine are: "(1) receipt by a taxpayer of money or other property, (2) control by the taxpayer over the utilization or disposition of money or property, and (3) assertion of some claim of right or entitlement by the taxpayer to receipt." Dubroff, *supra* note 110, at 733. Professor Dubroff believes that the third element may no longer be necessary. *Id. Dominion Res., Inc.* 219 F.3d at 364, lends credence to this view.

149. *See, e.g., United States v. Skelly Oil, Co.*, 394 U.S. 678, 683-84 (1969); I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967) ("It has long been recognized that any party who restores funds that he initially received and held under a claim of right will thereby become entitled to take a business expense deduction for the year in which the repayment transaction is actually carried out."); *accord, Cinergy Corp. v. United States*, 55 Fed. Cl. 489, 509 (2003) ("[T]o qualify for section 1341 relief, a taxpayer must be authorized to deduct the item at issue under some other provision of the Code.").

reasonable compensation.¹⁵⁰ The Tax Court in *Oswald v. Commissioner*, allowed the deduction of a payback of “unreasonable compensation” pursuant to a binding obligation (bylaw) entered into prior to the taxpayer’s earning the compensation after Service disallowance.¹⁵¹ The court reasoned that employer compulsion rendered the repayment deductible.¹⁵² The Service followed this reasoning in Revenue Ruling 69-115.¹⁵³ The Tax Court, in contrast, allows no deduction for such repayments if the repayment contract was entered into after the close of year one.¹⁵⁴ Yet, there is the same employer compulsion to follow the bylaw or

150. Some, but not all, courts view entering into a payback agreement as an indicia of unreasonable compensation. *See, e.g., Charles Schneider & Co., Inc. v. Comm’r*, 500 F.2d 148, 155 (8th Cir. 1974) (“An element reflecting on the intent of the parties as to the potential effect of these agreements is the fact that the bylaws of these corporations were amended shortly after the agreements were adopted to require the employees to repay to the companies amounts which they received under the agreements but which were later declared by a court not to be deductible expenses for tax purposes.... This may reflect a pre-existing knowledge on the part of the taxpayers that the payments would not be reasonable for tax purposes, and could lead to an inference as to their intent.”); *Saia Electric, Inc. v. Comm’r*, 33 T.C.M. (CCH) 1357 (1974) (discussing addendum to contract of corporate president obligating reimbursement to corporation of excessive or unreasonable payments). *Contra Menard, Inc. v. Comm’r*, 560 F.3d 620, 624 (7th Cir. 2009) (Posner, J.) (“Given the fondness of the IRS and the Tax Court for a ‘totality of the circumstances’ approach to determining excessive compensation, it was prudent ... for the company to require him to reimburse it should the IRS successfully [deny] the deduction.”). *See generally* Dubroff, *supra* note 110, at 754-55 & n.131.

151. 49 T.C. 645 (1968), *acq.* 1968-2 C.B. 2.

152. *Id.* at 647-48. Oswald returned the \$5,000 after receiving legal advice that the bylaw was enforceable and the repayment was necessary. If he had not repaid it, it could have been withheld from his later salary. It was a deductible expense of his business as an officer of Electric [Manufacturing & Repair Co.] under the circumstances of its return to Electric. *Id.* at 648.

153. 1969-1 C.B. 50. The Service has since expressed unhappiness with this position when the employee controls the corporation with no minority unrelated interest. *See* I.R.S. Gen. Couns. Mem. 35,557 (Nov. 8, 1973); I.R.S. Gen. Couns. Mem. 35,484 (Sept. 17, 1973). IRS General Counsel Memo 35,484 holds that no deduction is allowable under a repayment agreement where there exists no substantial adverse interest. The more sound approach would be to require a business purpose for the arrangement, not just a tax reduction. This approach was rejected in *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983). *See infra* note 159.

154. *See infra* note 265 discussing *Pahl v. Comm’r*, 67 T.C. 286 (1976). In *Pahl* the court held that taxpayer was not entitled under either Section 1341(a) or 162(a) to a deduction for the 1972 restoration of amounts attributable to the period prior to the execution of the Dec. 14, 1970 agreement, but was entitled to a deduction for the repayment of amounts attributable to the period after Dec. 13, 1970. *Id.* at 289-90. The distinction to the *Pahl* court was as follows:

contractual terms.¹⁵⁵ Judicial analysis finding that if the repayment agreement is executed after the year one payment, repayment in year two is voluntary, is conclusory, and ignores the business necessity of obeying the agreement regardless of the date of entry into the agreement.¹⁵⁶ Indeed, on very similar facts, the Service had earlier ruled that Section 1341 was not available as to any repayment because the shareholder-employee had an absolute right to the compensation in the year of payment;¹⁵⁷ “repayment was subject to a condition subsequent, an audit.”¹⁵⁸ The better analysis is to ask whether there was a business purpose for the repayment, e.g. to help

As to the deductibility of the 1972 restoration, a distinction must be made between the amounts petitioner received prior to the execution of the contract on December 14, 1970, and the amounts received after that date. At the time petitioner received the pre-December 14, 1970, payments (totaling \$318,248.01), he had no obligation to restore them regardless of whether K-P-F was allowed deductions for them. Rather petitioner had an unrestricted right to his salary payments for 1969 and 1970 received prior to December 14, 1970, and to the incentive compensation for all of 1969 and the first three quarters of 1970 when they were received. This right was not qualified by any circumstances, terms, or conditions existing at the time of the receipt of those sums. His *subsequent contingent voluntary agreement* of December 14, 1970, required, in part, that petitioner reimburse his employer for any of the already-received amounts that were, at some future date, disallowed as income tax deductions to his employer. Such agreement, however, will not support a 1972 deduction for his repayments to K-P-F in that year of the excessive amounts totaling \$318,248.01 received before December 14, 1970.

Id. (emphasis added); see also *Blanton v. Comm’r*, 46 T.C. 527 (1966), *aff’d. per curiam*, 379 F.2d 558 (5th Cir. 1967); *Berger v. Comm’r*, 37 T.C. 1026, 1031 (1962) (holding that repayment by taxpayers in 1956 of a portion of their salaries for prior years was voluntary and did not give rise to any deduction under the claim of right doctrine where payback agreement entered into after IRS audit).

155. The Service disagrees, see *supra* note 153. This is why some courts use the term “voluntary.”

156. See *Menard, Inc. v. Comm’r*, 560 F.3d 620 (7th Cir. 2009); see also *infra* notes 159-61 and accompanying text.

157. Rev. Rul. 67-437, 1967-2 C.B. 296 (“If the instant taxpayers in a subsequent year should repay the disallowed amounts to the corporation, it will not be because it was established after the close of the prior taxable year in which the money was received that the taxpayers did not have an unrestricted right thereto in such prior year, but because a liability on their part has later accrued which does not in any way establish that they had no right to the money when received.”). The payback agreement appears to have been in place before any compensation subject to it was paid.

158. I.R.S. Gen. Couns. Mem. 37,429 (Feb. 24, 1978); accord Rev. Rul. 67-48, 1967-1 C.B. 50.

maintain the employee's business reputation, or instead just a tax avoidance purpose.

No deduction under Section 1341 or the common law claim of right doctrine is correct under a balancing entry "fundamentally inconsistent event" analysis as to paybacks of amounts paid in year one and paid back under contracts entered into after year one.¹⁵⁹ Unless the payback contract was in place in year one at the time the "unreasonable compensation" was received, no assumption is made (i.e., that the salary would not have to be repaid), that has to be reversed in year two. Following *Hillsboro's* inconsistent event analysis (assume for the sake of analysis all events occur within year one), a payback in year one with no contractual or other binding obligation would be voluntary (typically a contribution to capital).¹⁶⁰ Under the *Oswald* Section 162 compulsion analysis, a deduction would be supportable: had the payback, pursuant to an obligation, occurred in year one, a deduction would have offset the income.¹⁶¹ Thus, one triggering event for a claim of right deduction often imported into Section 1341, is a year two payment pursuant to compulsion, the legal or contractual basis for which was in place in year one.¹⁶² The Tax Court has indicated that compulsion of a legal requirement is too rigid; voluntary tax

159. *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983). In *Van Cleave*, the Service contended that taxpayer was only entitled to a deduction in the year he repaid the compensation, because he had more than a mere appearance of an unrestricted right to the income in the year it was received. *Id.* at 196. The district court agreed. *Id.* at 195. On appeal, the 6th Circuit reversed, holding that taxpayer was entitled to the benefit of Section 1341, even though he had an unrestricted right to the income in the year received, and it was only in the following year that his right to the money became restricted. *Id.* at 197.

160. *See Quinn v. Comm'r*, 524 F.2d 617, 624 (7th Cir. 1975) (discussing necessity to business of being officer of corporation to obey by-law).

161. *See Oswald v. Comm'r*, 49 T.C. 645 648-49 (1968). *But see Blanton v. Comm'r*, 46 T.C. 527, 530-31 (1966), *aff'd, per curiam*, 379 F.2d 558 (5th Cir. 1967).

According to the circumstances, terms, and conditions of the original payments of director's fees to petitioner, petitioner was never obligated at any time to return any portion of said fees to the corporation. It was only after petitioner received the director's fees that he voluntarily entered into the repayment contract which may or may not have been binding upon him. However, the fact that the contract may have been binding upon petitioner does not change the essentially voluntary nature of his decision to enter into it.

Id. at 530.

162. *See Dubroff, supra* note 110, at 753; *Lee & Bader, supra* note 37, at 210 & n.459; *see also* I.R.S. Gen. Couns. Mem. 35,557 (Nov. 8, 1973).

avoidance is not sufficient, but external events virtually mandating repayment may trigger Section 1341.¹⁶³

The Service's stance that a subsequent unfulfilled year two condition does not trigger Section 1341 is incorrect.¹⁶⁴ Another fault in the Service's position is that it believes the claim of right doctrine applies in year one even though "continued enjoyment of such funds is subject to a restriction which is merely 'potential or dormant' in the sense of being dependent upon a possible future application of rules of law to present facts."¹⁶⁵ Further, if the restriction comes into play within the same tax year and the taxpayer makes restitution in that year, "such restitution necessarily precludes the realization of any overall net income."¹⁶⁶ And, if the taxpayer makes repayment in year two he or she "will thereby become entitled to take a business expense deduction for the year in which the repayment transaction is actually carried out."¹⁶⁷ Clearly, if the common law claim of right doctrine's year two deduction for repayments applied, the taxpayer would be able to use Section 1341.

Authorities disagree as to whether Section 1341 applies when the taxpayer in year one had an absolute or actual right to the item of income rather than only an apparent right. The Service frequently argues that where the taxpayer's right to income becomes restricted only upon the occurrence of an event in year two, the unrestricted right in year one is more than apparent—it is actual, and Section 1341 is unavailable.¹⁶⁸ The Service maintains that the year two events must show that the taxpayer did not have an unrestricted right at the end of year one, thus the year two facts must show that the taxpayer's right was only apparent as of the end of year one.¹⁶⁹ If this were interpreted as only requiring a contingent obligation in year one to make the year two repayment if certain

163. *Barrett v. Comm'r*, 96 T.C. 713, 722 (1991).

164. Rev. Rul. 67-437, 1967-2 C.B. 296; *contra Van Cleave*, 718 F.2d 193.

165. I.R.S. Gen. Couns. Mem. 36,602 (Aug. 25, 1967).

166. *Id.*

167. *Id.* (relying on *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932), and *Pike v. Comm'r*, 44 T.C. 787 (1965), for claim of right and early BTA salary adjustment cases, and *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954), for year-end netting).

Where both the initial receipt of funds and the repayment of some portion thereof take place in the same year, there cannot very well be a serious question about the overall propriety of excluding the amount so repaid from the taxable income of the party who has thus effectively relinquished or disavowed any claim thereto.

Id.

168. I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967).

169. *See Van Cleave*, 718 F.2d at 197; *see also supra* note 153.

assumptions in year one turn out in year two to be erroneous, it is supported by case law, legislative history, and the balancing entry model. The Service has conceded that neither Section 1341 nor the accompanying regulations address

whether the determination that the taxpayer did not have an unrestricted right to the income in question has to be based on facts that existed as of the close of the taxable year in which the taxpayer received the income, or could instead be based on events that occurred after the close of the taxable year of receipt.¹⁷⁰

The Service still maintains that the former position is the correct one, but no court presented with this argument has adopted it.¹⁷¹ The Claims Court disagreed with *Dominion Resources* in *Cinergy Corp. v. United States*: “[T]he claim of right doctrine simply does not apply where an individual receives an item of income under an ‘absolute’ right.”¹⁷² The true debate is whether a taxpayer only *appears* to have an absolute right to an item of income where, in the year of receipt, there is an implicit condition subsequent which will require a repayment in year two if certain facts come to pass in that year so that the condition is not fulfilled. In *Dominion Resources*, the condition subsequent was that the deferred taxes for which a reserve was held would *not* be reduced by an income tax rate decrease.¹⁷³

Although DRI’s right to keep the income was not explicitly conditioned on the tax rate remaining at 46%, from the outset the tax rate was an obvious and central circumstance under which the regulatory

170. *Dominion Res., Inc. v. United States*, 219 F.3d 359, 364 (4th Cir. 2000) (referring to the Commissioner’s brief). IRS relies not on a regulation but rather on a small group of revenue rulings now more than thirty years old. *See* Rev. Rul. 69-115, 1969-1 C.B. 50; Rev. Rul. 67-437, 1967-2 C.B. 296; Rev. Rul. 67-48, 1967-1 C.B. 50; Rev. Rul. 58-456, 1958-2 C.B. 415; Rev. Rul. 58-226, 1958-1 C.B. 318. *Id.* at 366.

171. *See id.* at 366 (“Although the tax court has on occasion denied certain taxpayers the right to avail themselves of § 1341, it has never adopted the IRS’s distinction between actual versus apparent claims of right as the basis for such decisions.... Moreover, both circuits that have considered a similar IRS contention with respect to § 1341(a) have flatly rejected it.”); *Prince v. United States*, 610 F.2d 350, 352 (5th Cir. 1980) (“The basis of the district court’s decision and of the government’s position on this appeal is that the section is inapplicable here because Margaret Bush had an actual unrestricted right to the trust income in question, and not just an appearance of such a right.... The Alabama judgment established, whether expressly or by implication, that the deductions from the trust income for the ten year fee had been miscalculated. As a result, Margaret Bush had received more income from the trust than she was entitled to receive. This income had to be returned. The requirements of Section 1341 were thus clearly satisfied.”).

172. 55 Fed. Cl. 489, 503-04 (Fed. Cl. 2003).

173. *Dominion Res.*, 219 F.3d at 368.

authorities permitted DRI to collect the \$10 million. As one DRI official testified, “our expectation was all along that if there was any excess [collection for] deferred taxes resulting from the tax decrease that those amounts would be refunded to customers or returned to customers.” Certainly anyone familiar with public utility regulation would have shared that expectation.¹⁷⁴

The Claims Court in *Cinergy* refused to find such a condition subsequent.¹⁷⁵

The Fourth Circuit, in *Dominion Resources*, pointed to the proper non-statutory requirement (supported by the balancing entry model and implicit in the cases discussed immediately below): “the requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer.”¹⁷⁶ The court’s application of this test was, however, quite liberal.¹⁷⁷ “It did ‘appear that’ DRI had an unrestricted right to the income, and it was established in a later year that DRI did not have an unrestricted right to that same item of income.”¹⁷⁸ A literal reading of this formulation supports application of Section 1341 to a 2009 repayment of a bonus received in 2008.

Functionally, the applicability of a *Dominion Resources* implicit condition precedent should turn on whether, at the time of the payment of retention bonuses in December 2008 by a TARP beneficiary, Congress and the media had already expressed sufficient opposition to such bonuses that, while the right to keep the bonuses was not expressly conditioned on a low level of political and popular opposition, rescission was a strong possibility if existing criticism escalated. In fact, at the time that AIG paid the bonuses in 2008, politicians and the media had already expressed the desirability of a cap on bonuses in general, and especially criticized AIG’s retention bonuses to executives.¹⁷⁹ A demand for repayment by AIG made by Federal or State governments if the bonuses were paid was perhaps not as inevitable as was the required repayment in *Dominion Resources* of part

174. *Id.*

175. *Cinergy*, 55 Fed. Cl. at 506-07 (2003) (“[T]his is not a case where a utility obtained funds in one year based upon a mistaken calculation or the seeming triggering of a condition precedent later found not to have occurred.”).

176. *Dominion Res.*, 219 F.3d at 367 (quoting *Pahl v. Comm’r*, 67 T.C. 286, 290 (1976)).

177. *Dominion Resources* accurately concluded that Congress intended Section 1341 as a remedial statute. *Id.* at 362-63. Such remedial provisions are given a liberal interpretation. See *Koss v. United States*, 69 F.3d 705, 709 (3d Cir. 1995).

178. *Dominion Res.*, 219 F.3d at 368.

179. See *supra* note 36 and accompanying text.

of a reserve for future income taxes if future income rates were reduced from the year one rates.¹⁸⁰ On the other hand, the 2008 AIG facts are close to those in *Penn v. Robertson*, which permitted tax rescission within the same year when a bonus was challenged in a shareholder derivative suit filed contemporaneously with the payment.¹⁸¹ Similarly, a year two payment by a broker to settle civil suits brought in year two warranted application of Section 1341.¹⁸²

Assuming, therefore, that Section 1341 applies to any repayment in 2009 of executive bonuses paid in 2008, two additional points arise: (1) if application of the alternative computation restoration creates a greater reduction in 2008 taxes than the 2009 taxes computed without the deduction in 2009 of the restoration (as it likely would), such excess creates a NOL carry-back offsetting the 2008 taxes on the bonus, and hence an instant refund of those taxes in 2009;¹⁸³ and (2) to the extent additional FICA (Federal Insurance Contribution Act) taxes (including social security and Medicare taxes) were paid in the prior year because of the erroneous salary payment, the repayment of the salary in a subsequent year creates an overpayment of FICA taxes in the prior year, and credit may be claimed by the employer with respect to its FICA tax liability for that prior year subject to the statute of limitations.¹⁸⁴

180. *Dominion Res.*, 219 F.3d at 368.

181. *Penn v. Robertson*, 115 F.2d 167, 169-72 (4th Cir. 1940); *see also infra* notes 204 and 210 and accompanying text.

182. *See supra* note 29 discussing *Barrett v. Comm'r*, 96 T.C. 713 (1991).

183. I.R.S. Gen. Couns. Mem. 34,606 (Sep. 10, 1970); *see* I.R.C. § 1341(b)(1) (2006) (excess of decrease in tax for year one arising from excluding year one payment restored over taxes for year two computed without deduction for repayment, is treated as if overpayment for year two and is refunded (or, if elected, credited towards year three taxes)).

184. I.R.S.S.C.A. 1998026 (Significant Service Center Advice Re: Wage Overpayment Taxability) (Dec. 4, 1998); *see also id.* ("Repayments of salary received in a prior year do not reduce the amount of wages paid to the employee for FICA and federal income tax withholding purposes in the year of the repayment. Thus, any remuneration for employment in the year of repayment which is used to repay the erroneous salary is not excludable from wages for FICA and federal income tax withholding purposes. Also, the repayment of salary does not reduce gross income for the prior year or affect the amount of income tax withheld in the prior year."); Rev. Rul. 79-311, 1979-2 C.B. 25; I.R.S. Field Serv. Adv. Mem. 200129001 (Mar. 20, 2001).

b. Rescission or Netting at Year End

Strict and liberal lines of authorities also conflict as to taxation of a payment and of its repayment in the same year.¹⁸⁵ The "strict view" is that if the taxpayer-employee receives the payment without restrictions or conditions subsequent and the employee's repayment within the same year could not be required under local law by the employer, the payment must be included in the employee's income under a claim of right. Moreover, the repayment within the same year is often held to be personal and, hence, non-deductible.¹⁸⁶ The liberal view is that, where prior to the close of the taxable year, the contract or obligation is adjusted and the taxpayer-employee repays the amount received, the tax liability is to be determined on the basis of the adjusted amount.¹⁸⁷

The better, but seldom recognized, dichotomy is between those authorities requiring the existence of a condition subsequent that would mandate repayment if the condition is met at the initial time payment is due,¹⁸⁸ and those authorities that do not require the condition. The seminal liberal cases would have yielded the same result under the strict view, viz., either a mistake as to amount,¹⁸⁹ because subsequent events in the same tax year that constituted an express condition subsequent requiring repayment, or the presence at the time of payment of developments that might induce the corporation and employee to rescind the payment and restore the status

185. See *United States v. Simon*, 281 F.2d 520, 525 (6th Cir. 1960).

Where the individuals received the funds under claim of right and in subsequent years came under obligation to repay the money, they are entitled to deductions in the year of repayment. The Government accedes to the correctness of this statement, but contends that "it has absolutely no application where a taxpayer returns to the payer income which he has received in an earlier year when there is no legal or moral obligation requiring its return. The word "obligation" has been interpreted both liberally and strictly by the courts.

Id.; see also I.R.S. Gen. Couns. Mem. 34,606, at 2-3 (Sep. 10, 1970) (liberal interpretation of Section 1341).

186. The reason for the repayment invariably was for income tax savings, which is not a business purpose. See, e.g., *Nat'l Life and Accident Ins. Co. v. United States*, 244 F. Supp. 135, 138 (M.D. Tenn. 1965) (citing *United States v. Simon*, 281 F.2d 520 (6th Cir. 1960); *Crellin's Estate v. Comm'r*, 203 F.2d 812 (9th Cir. 1953)), *aff'd* 385 F.2d 832 (6th Cir. 1967).

187. See *infra* notes 229-48 and accompanying text.

188. For example, this could be a mistake of fact or an explicit or implicit requirement of repayment if a specified condition subsequent, such as a suit demanding rescission of the payment, occurs before year end.

189. The Service came to oppose a condition subsequent as not satisfying Section 1341. See *supra* notes 168-69 and accompanying text.

quo ante.¹⁹⁰ The lines of liberal cases came, however, to encompass reimbursement of payments that had been made without any of these factors—permitting undoing within the same year of any payments, even if repayment was prompted by subsequent tax purposes of the corporation or the employee.

The most frequently cited decisions in this context are: (1) *Crellin's Estate v. Commissioner*,¹⁹¹ (2) *United States v. Merrill*,¹⁹² (3) *Penn v. Robertson*,¹⁹³ and (4) *Couch v. Commissioner*.¹⁹⁴ *Crellin's Estate* held that, where a dividend is received under a claim of right without restriction on its use, and in the same year the corporation and shareholders “rescinded” the dividend paid, due to a mistake of tax law,¹⁹⁵ the rescission did not compel the return of the dividend payments.¹⁹⁶ Repayment in such case was a “voluntary act” which “cannot create a deduction in any year.”¹⁹⁷ The court concluded that, “for tax purposes, it is that which the holding company could have compelled, not that in which the stockholders were willing to acquiesce, which controls. Otherwise, the taxpayers in this case could lift the federal tax-hand; to suit their convenience.”¹⁹⁸

The Tax Court followed *Crellin's Estate* in finding that the corporation could not have legally compelled restoration of parts of salaries paid in prior years; hence, the shareholder-employee repayment was “voluntary”

190. *Penn v. Robertson*, 115 F.2d 167, 173 (4th Cir. 1940).

191. 203 F.2d 812 (9th Cir. 1953), *cert. denied*, 346 U.S. 873 (1953).

192. 211 F.2d 297 (9th Cir. 1954) (60 citing decisions, many distinguishing or criticizing).

193. 115 F.2d 167 (4th Cir. 1940) (49 citing decisions).

194. 1 B.T.A. 103 (1924), *acq.*, 1925-1 C.B. 1 (39 citing decisions).

195. *Crellin's Estate*, 203 F.2d at 813. The board declared a dividend following erroneous advice that income, unless distributed, would be subject to the personal holding company surtax. *Id.* Later in the same year it learned that such advice was erroneous and believing that a recall of the dividends would decrease the taxable income of the stockholders and permit an advantageous investment by the corporation of the returned distributions, the corporation passed a resolution “rescinding” the dividend and demanding that the stockholders return the amounts paid to them. *Id.* The stockholders complied before the end of the year. *Id.*

196. *Id.* at 814.

197. *Id.*

198. *Id.* at 815. The passage quoted in *Crellin's Estate* stated in full that “it is not given to a taxpayer to lift the federal tax-hand from income, which he has once received in absolute right, by an attempt thereafter to alter its legal status through modification of the agreement out of which it arose.” *Leicht v. Comm'r*, 137 F.2d 433, 435 (8th Cir. 1943) (holding that amounts received as salary cannot be retroactively changed during the same year by the modification of the salary agreement or by resolution of the board of directors of a corporation).

and “did not give rise to any deduction under the ‘claim-of-right doctrine.’”¹⁹⁹ These voluntary cases tend to involve retroactive (within the tax year or even after the close of the tax year) rescissions or obligations to repay that are motivated by tax avoidance, or at least reduction of the corporation’s and/or the individual taxpayer’s federal income taxes.²⁰⁰

In *United States v. Merrill*,²⁰¹ the Ninth Circuit held that where a taxpayer had mistakenly paid executor’s fees to himself from his late spouse’s estate for two years and discovered the mistake in the second year, the fees paid by the estate in the first year had to be reported under the claim of right doctrine.²⁰² As to the second year, however, the claim of right doctrine was inapplicable and the erroneous fees were excluded from gross income because “in the same year that the funds [were] mistakenly received, the taxpayer discover[ed] and admit[ted] the mistake,

199. *Berger v. Comm’r*, 37 T.C. 1026, 1031 (1962); *id.* at 1032 (“Petitioners make some argument on brief that in order to come under the claim-of-right rule it is not necessary that repayment be made under a ‘legal compulsion’ but that it is enough if the repayment is made ‘in good faith and in the exercise of a sound business judgment.’ There is no merit in this argument. It can readily be seen such a ‘sound business judgment’ standard would allow the employee-stockholders to contribute capital to their corporation by the mere label of excessive salary repayment, and secure deduction of the contribution on their own returns. The great weight of authority is that the payee must have at least the ability to legally compel the repayments before the repayments can be deducted by the payor.”); *cf.* *Barrett v. Comm’r*, 96 T.C. 713, 719 (1991), *non-acq.*, 1992-1 C.B. 1 (following *Berger* but holding that “[t]o conclude that petitioner restored the \$54,400 voluntarily without regard to any legal obligation would, in our view, be ludicrous. The SEC had initiated administrative proceedings in which it presumably sought, among other things, to compel a restoration of all of petitioner’s option trading profit as well as the removal of his license as a broker. Petitioner along with others had been sued for \$10 million. A hearing had been held in those suits before a U.S. magistrate who, it appears, was of the view that the plaintiffs could present sufficient evidence to require submission of the matter to a trial court jury. The magistrate urged the parties to settle the suits. With several other defendants involved, petitioner could not have known what evidence would be presented at a trial. He could not have known how the jury would view his own testimony and that of others on the circumstances in which he bought and sold the options. At this point, petitioner settled the suits and restored the \$54,400. All of these facts clearly indicate that the settlement was made in good faith and at arm’s length; there is no evidence to the contrary, and respondent does not suggest that the settlement was collusive. The settlement, whether or not embodied in a judgment, established the fact and the amount of petitioner’s legal obligation.”). *Non-acquiescence* was based on a failure in the record to show this nexus. I.R.S. *action on dec.*, 1992-08 (Mar. 13, 1992).

200. *See Oswald v. Comm’r*, 49 T.C. 648 (1968).

201. 211 F.2d 297 (9th Cir. 1954).

202. *Id.* at 304.

renounce[d] his claim to the funds, and recognize[d] his obligation to repay them.”²⁰³

In *Penn v. Robertson*,²⁰⁴ a corporation sold to executives in January 1931 shares of its stock at a price less than 25% of fair market value.²⁰⁵ A shareholder derivative suit was filed within two weeks, another within two months, and another within nine months.²⁰⁶ On the advice of counsel, the corporation rescinded the plan before the end of the year.²⁰⁷ In the rescission the taxpayer’s estate returned the stock and \$31,500 in credited dividends to the corporation—all before the end of 1931.²⁰⁸ “The whole transaction was thus consummated within the calendar year 1931 on the basis of no profit and no loss to either Penn or the [corporation].”²⁰⁹ *Penn* held that the rescission in 1931 before the close of the year, “extinguished what otherwise would have been taxable income to Penn for that year.”²¹⁰ Note that in this case challenges to the payments were raised contemporaneously with the payments.

Finally, *Couch v. Commissioner*,²¹¹ one of the earliest Board of Tax Appeals decisions, held that where the taxpayer-employee and the corporation reduced the amount of his compensation before the end of the

203. *Id.* The court went on to conclude that:

[T]here is no warrant for extending the harsh claim of right doctrine to such a situation. In such case the Internal Revenue Bureau is not faced with the problem of deciding the merits of the claim to the funds received, for the question has been resolved by the interested parties. No question is here raised as to the *bona fides* of appellee’s 1940 bookkeeping entries relative to the mistaken payments. Good faith is indicated by the fact that the taxpayer’s \$7500 obligation to the estate was not only recognized by him in 1940 but was paid in cash in 1943.

Id.; accord *Clark v. Comm’r*, 11 T.C. 672 (1984), *non-acq.*, 1949-1 C.B. 5, *acq.*, 1954-1 C.B. 3 (amounts of salary employee agreed before end of year to repay not taxable even though repayment not made by time of decision). The Service has also held that that a taxpayer does not have an “absolute right” to income under the accrual method of accounting where an error is discovered within the same tax year. Rev. Rul. 2003-10, 2003-1 C.B. 288.

204. 115 F.2d 167 (4th Cir. 1940).

205. *Id.* at 170. The stock was held in trust with dividends to be applied to the purchase price. *Id.*

206. *Id.* at 171. Contemporaneously, dividends of \$31,500 were credited to the taxpayer. *Id.*

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.* at 175.

211. 1 B.T.A. 103 (1924) *acq.*, 1925-1 C.B. 1.

tax year due to its "straightened financial circumstances," he was to be taxed only on the reduced amount.²¹²

Though seemingly at odds, these seminal cases are all reconcilable. In *Crellin's Estate*, when the taxpayer received the dividend, the amount was not in error, and the receipt was not subject to challenge. The purported rescission was because the dividend payment had been based upon erroneous tax advice.²¹³

In *Merrill*, the taxpayer received the executor's fee from his deceased spouse's estate *erroneously* and corrected the error within the same tax year by acknowledging the error and agreeing to pay the fee back to the estate.²¹⁴ This is similar to the error in *Lewis* as to the amount of the bonus.²¹⁵

In *Penn*, when the taxpayer was credited with \$31,500, the employer's plan was being challenged in the courts contemporaneously so that the taxpayer was aware that he and the corporation might be compelled to rescind the payment.²¹⁶ Similarly, Revenue Ruling 80-58, relying on the *Penn* rescission doctrine, held that no gain is recognized under Section

212. *Id.* at 103

213. *Crellin's Estate v. Comm'r*, 203 F.2d 812, 814 (1953).

214. *United States v. Merrill*, 211 F.2d 297, 298-99 (9th Cir. 1954); *see also* *Hightower v. Comm'r*, 90 T.C.M. (CCH) 530 (2005), *aff'd*, 266 Fed. Appx. 646 (9th Cir. 2008) (discussing how *Merrill* "held that a payment mistakenly made to a taxpayer who had no right to receive it is not taxable in the year of receipt if, in that year, the taxpayer renounces any claim to the funds, recognizes an obligation to repay, and makes provision for repayment in the form of a journal entry on the taxpayer's books"). Of course, merely agreeing today to pay back the erroneous amount would not back out the original receipt; the taxpayer would have to pay it back in the same tax year. *See Quinn v. Comm'r*, 524 F.2d 617, 624, 626 (7th Cir. 1975) ("*Merrill* was incorrectly decided.... Thus, recognition of the obligation to repay funds received under a claim of right has no tax consequences regardless of whether it occurs in the year the funds were received or a later year."); *accord Buff v. Comm'r*, 496 F.2d 847, 849 (2d Cir. 1974) (Oakes, J., concurring) ("*Merrill* runs contrary to the theory underlying the concept of annual accounting, at least in the case of cash basis taxpayers.... In short, giving credence in the case of a cash basis taxpayer to an agreement to repay, whether in the same year of receipt, is a gross misuse of the annual accounting concept; a repayment agreement per se should be viewed as a nullity for tax purposes."). The Service has not always recognized this error in *Merrill*. *See, e.g.*, I.R.S. Field Serv. Adv. Mem. 200124008 (Mar. 14, 2001). *But see Davis v. United States*, 226 F.2d 331, 334 (6th Cir. 1955). This subsequent obligation to repay may be distinguished from a situation where the taxpayer had no right to keep the money when received and has an obligation to pay it to another. *See Comm'r v. Indianapolis Power & Light, Co.*, 493 U.S. 203 (1990).

215. *United States v. Lewis*, 340 U.S. 590 (1951) (deciding case where taxpayer who received and reported improperly computed bonus in 1944 repaid erroneous amount in 1946 after losing in employer's suit to recover such amount).

216. *Penn v. Robertson*, 115 F.2d 167, 171 (1940).

1001 on the sale of land where, pursuant to a condition precedent clause in the contract of sale, the taxpayer accepts reconveyance of it and returns the buyer's payment in the year of sale.²¹⁷

In *Couch*, the compensation contract was modified *before* the compensation was received. The Board relied heavily on the good faith of the employee and the corporation and in effect found a condition subsequent:

Salary arrangements between corporations and their principal stockholders and managers in cases like this one, where the manager is expected by his associates to protect the interests and the future prospects of the company even at a sacrifice to himself, are and must be at all times subject to such modifications as may be made by agreement from time to time; and it appears to us that the arrangement entered into by this taxpayer and this corporation in the month of December, 1920, clearly shows an intent on the part of both sides to modify the prior existing agreements in regard to this taxpayer's compensation, and that such modification was actually made in good faith and the accounts of the company adjusted accordingly.²¹⁸

The Tax Court in *Jones v. Commissioner* accurately read *Couch* and its early progeny: "the original *salary* agreements present in each of these cases were found to be subject to modification by the taxpayers and their employers and not absolute."²¹⁹

i. Evolution of Rescission and Year End Netting Cases

The Tax Court in *Bishop v. Commissioner*²²⁰ applied *Merrill* to a fact pattern in a manner that more closely resembled *Penn* than a mistake regarding the payment amount. In *Bishop*, a "minority stockholder of a corporation" claimed that the majority shareholders, "who were partners in two other businesses were conducting their partnership businesses in a manner detrimental to the corporation."²²¹ The majority settled the suit by turning over the partnership income to the corporation in the year it was

217. Rev. Rul. 80-85, 1980-1 C.B. 181. This notion of implicit or explicit condition subsequent underlying the *Penn* rescission within the same year doctrine may explain the citation in I.R.S. Gen. Couns. Mem. 38,241 (Jan. 8, 1980) to *Penn*, as well as *Healy*, as authorities for the claim of right doctrine holding "that where a taxpayer has the unrestricted use of income in a taxable year, he is taxed on that income." I.R.S. Gen. Couns. Mem. 38,241, *supra*.

218. *Couch v. Comm'r*, 1 B.T.A. 103, 105 (1924).

219. 82 T.C. 586, 591 (1984); *accord* *McEwen v. Comm'r*, 6 T.C. 1018, 1025 (1946).

220. 25 T.C. 969 (1956), *acq.*, 1956-2 C.B. 3. The claim of right doctrine does not apply if the taxpayer renounces any right to the income, either before or immediately after receiving it. *Id.* at 974.

221. *Id.* at 969.

received, thereby renouncing their claim of right to such income, which the court held resulted in no taxable income to them.²²² The Tax Court, however, has recently distinguished *Merrill* where there is no mistake as to the original payment.²²³ In contrast, the Second Circuit readily followed *Merrill* where “the duty to return was pre-existing and adherent to the payment itself, and [the] payment and return were simultaneous.”²²⁴ The

222. *Id.* at 974-75; accord Rev. Rul. 58-456, 1958-2 C.B. 415.

223. *Hightower v. Comm’r*, 90 T.C.M. (CCH) 530 (2005) (holding that the case differed from *Merrill* “because the payment of funds was not a mistake, [taxpayer] had the right to receive the funds, and there was no existing agreement ... to return the payment”), *aff’d*, 266 Fed. Appx. 646 (9th Cir. 2008) *cert. denied*, 129 S. Ct. 518 (2008); accord I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967):

There are likewise persuasive precedents for concluding that a cash basis taxpayer can avoid having the so-called claim of right doctrine applied against him with respect to funds mistakenly received as income during a particular taxable year without actually restoring such funds to their rightful owner in the same year he receives them, if he is sufficiently prompt in clearly renouncing any claim thereto. It was directly so held in *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954) where an executor who had initially collected an excessive fee from an estate in both 1939 and 1940 discovered his mistake after having received the full fee originally contemplated and thereupon acknowledged an obligation to restore more than his last year’s collections by making appropriate entries to that effect during 1940 on both the estate’s books of account and his own personal books. Both the Tax Court and Fifth Circuit appear to be in accord with the result reached in this *Merrill* case. See *Charles Kay Bishop*, 25 T.C. 969 (1956) (Acq. C.B. 1956-1, 3) and *Commissioner v. Gaddy*, 344 F.2d 460 (5th Cir. 1965).

Id.

224. *Frelbro Corp. v. Comm’r*, 315 F.2d 784, 787 (2d Cir. 1963).

[A] taxpayer, who by mistake consummates a transaction in a manner that is not in accord with his actual intent, may, in the same tax year, with the consent of the other parties, reform the transaction so as to carry out his real intent, and ... such reformation will determine the federal tax consequences.

Davis v. United States, 378 F. Supp. 579, 582 (N.D. Tex. 1974); I.R.S. *action on dec.*, 1975-135 (May 13, 1975) (“We believe that this decision [*Davis*] is in conflict with the subsequent decision of *Commissioner v. Buff*, 496 F.2d 847 (2d Cir. 1974), *rev’d* 58 T.C. 224 (1972). While the majority of the court in *Buff* distinguished *Merrill*, the concurring opinion of Justice Oakes held that *Merrill* was incorrect because a cash-basis taxpayer who receives money in one year and merely renounces his claim to the money and promises repayment in the same year is not entitled to an offsetting deduction until he actually makes repayment. Based upon this rationale Mr. Davis would be entitled to no deduction in 1964 but would be entitled to a deduction upon repayment of his notes in 1965.”).

Service has often (usually in dicta) broadly stated this principle based on the renunciation exception to the claim of right doctrine, namely, that:

[t]he claim of right doctrine will not apply if the taxpayer renounces any right to the income, either before or immediately after receiving it. Also, for the renouncement to be effective, the right to the income must be renounced and the income repaid during the taxable year in which the money is received.²²⁵

Really this just proves that where repayment is made in the same year as a payment that was subject to an explicit or implied condition subsequent, the claim of right doctrine does not apply to the initial payment.²²⁶ Thus, the blogger who called any AIG executive who agreed to pay back part of his or her retention bonus a “sucker” started off with an erroneous assumption of an “absolute right.”²²⁷ The bloggers appear to have achieved their apparent goal of retarding paychecks since Liddy implied that employees were not returning any of their retention bonuses “pending resolution of certain tax implications.”²²⁸

ii. *Penn Progeny*

Again, loose language indicates that the rescission exception to the claim of right doctrine may apply without a mistake or condition subsequent, explicit or implicit, at the time of receipt of a payment, so long as rescission is agreed upon prior to year end and the parties are returned to status quo ante.²²⁹

[T]wo conditions that must be satisfied for the remedy of rescission to apply to prevent current recognition of gain from the disposition of a capital asset: (1) the parties to the transaction must return to the status quo ante; that is, they must be restored to “the relative positions they would have occupied had no contract been made;” and (2) this restoration must be achieved within the taxable year of sale.²³⁰

225. I.R.S. Field Serv. Adv. Mem., 1998 FSA LEXIS 190 (1998) (citations omitted) (relying on *Bishop v. Comm’r*, 25 T.C. 969 (1956)).

226. *Jones v. Comm’r*, 82 T.C. 586, 591 (1984).

227. See *supra* note 19 and accompanying text.

228. See *House AIG Hearing*, *supra* note 4, at 324.

229. See, e.g., *Hope v. Comm’r*, 55 T.C. 1020, 1031 (1971) (stating, in dictum that “[t]his Court is not faced with the situation where the sale is rescinded in the same year” where a suit for rescission was filed due to dissatisfaction with the sales price), *aff’d*, 471 F.2d 738 (3d Cir. 1973); accord *Hightower v. Comm’r*, 90 T.C.M. (CCH) 530 (2005), *aff’d*, 266 Fed. Appx. 646 (9th Cir. 2008).

230. I.R.S. Field Serv. Adv. Mem., 1994 FSA LEXIS 596 (Nov. 23, 1994) (citing *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940), and Rev. Rul. 80-58, 1980-1 C.B. 181).

The Service relied upon *Penn* in Revenue Ruling 80-58.²³¹ The ruling held that a sale of property was subject to rescission at any time during the nine months following the purchase by the buyer if he could not obtain rezoning for his business use.²³² The rescission²³³ placed the buyer and seller in the same positions at the end of the tax year as they were in prior to the sale.²³⁴ As stated by the Service, "the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction."²³⁵

The Service, in General Counsel Memorandum 39,690²³⁶ analyzed Revenue Ruling 80-58 as involving a condition subsequent which, if not fulfilled, would allow a buyer to obtain rescission of the purchase.²³⁷ Further progeny of this ruling came to simply require restoration to the same position by year's end for rescission disregarding a transaction without any condition subsequent.²³⁸ None, however, involved compensation.

231. Rev. Rul. 80-58, 1980-1 C.B. 181.

232. *Id.*

233. *Id.* The legal concept of rescission refers to the abrogation, cancelling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission. *Id.*

234. *Id.*

235. *Id.*

236. I.R.S. Gen. Couns. Mem. 39,690 (Jan. 15, 1988).

237. *Accord* I.R.S. Tech. Adv. Mem. 94-08-004 (Nov. 10, 1993); I.R.S. Field Serv. Adv. Mem., 1994 FSA LEXIS 782 (July 14, 1994) (revaluation clause).

238. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200-752-035 (Sept. 26, 2007). Before an S corporation sponsoring an employee stock purchase program under which employees could buy its stock had been advised that such stock could not be held by an individual retirement account (IRA), it permitted an employee's IRA to purchase stock under the program. *Id.* When its counsel advised it that an IRA was an ineligible shareholder, it rescinded the transaction, voiding the certificates representing stock issued to the IRA, and reissuing the same to the employee. *Id.* The Service ruled that because the rescission satisfied the requirements detailed in Rev. Rul. 80-58, 1980-1 C.B. 181, the S corporation was entitled to relief from the inadvertent termination of its S corporation status. *Id.*; *see also* I.R.S. Priv. Ltr. Rul. 200-752-025 (Dec. 28, 2007); I.R.S. Priv. Ltr. Rul. 200-701-019 (Jan. 5, 2007).

iii. Couch Progeny

In the earliest progeny of *Couch*, the compensation had been repaid by the end of the tax year of payment with the taxpayer-employee carefully couching the facts to include an “understanding” between the corporation and the employee: the employee would return part of his salary if the business could not pay the contractual amount due to business circumstances.²³⁹ Thirteen years after *Couch*, at the beginning of the Great Depression, cases began to allow taxpayers to exclude returned salary from gross income prior to the end of the year even though the repayment agreement was made after the compensation had already been paid.²⁴⁰ In *Curran Realty Co. v. Commissioner*, the taxpayer and its tenant, following a tax audit of the tenant, reduced before the end of the current tax year the amount of rent owed to the taxpayer to the amount of “reasonable” rent allowed by the audit.²⁴¹ The lessor-taxpayer made an adjusting entry to its financial record before the end of the tax year but refunded the excess to the tenant in the next tax year.²⁴² The taxpayer was allowed to exclude such excess from income in the current tax year.²⁴³ A year end adjustment

239. See *Fulton v. Comm’r*, 11 B.T.A. 641 (1928) (describing fact pattern where an “officer of a corporation during a taxable year return[ed] to the corporation” before the end of a tax year “part of salary received for the year [pursuant to] an agreement” with a majority of preferred shareholders “to accept less salary if the business [did] not warrant his regular salary, [the amount of salary] so returned [is not] includ[ible] in his gross income”); *Hill v. Comm’r*, 3 B.T.A. 761, 763 (1926) (“We are convinced from the evidence that there was an understanding among the officers and directors of the corporation that salaries should be set at the highest possible point in the hope that the business would justify them, but if unexpected claims developed, thereby reducing the income of the corporation, the officers would refund a portion thereof. All of the officers and directors of the corporation were active in the conduct of its business and interested in its success.”). *Jones v. Comm’r*, 82 T.C. 586, 591 (1984), read *Hill* as a case where “the original salary agreement[] present ... [was] found to be subject to modification by the taxpayers and their employers and not absolute.” *Id.* The same is true of *Fulton*.

240. *Russel v. Comm’r*, 35 B.T.A. 602, 603-04 (1937), *acq.* 1937-1 C.B. 22 (“The petitioner [president and director of Detroit Bevel Gear Co.] suggested that, in view of the showing which had been made by the company during the year 1930, his salary was excessive and should be reduced to \$4,200 per year, which was agreed to by Jenks and Navin. Thereupon, the petitioner delivered to the company his check dated December 23, 1930, payable to the order of the company in the amount of \$4,800, which amount included one-half of the salary previously received by him.”).

241. 15 T.C. 341, 342 (1950), *acq.*, 1951-1 C.B. 2, *non-acq.*, 1954-1 C.B. 8.

242. *Id.*

243. *Id.* at 343-44. But see *Buff v. Comm’r*, 496 F.2d 847, 850 n.2 (2d Cir. 1974) (Oakes, J., concurring) (“I do not find *Curran* ... in any way persuasive from an

was also held to limit the corporation's compensation deduction to the adjusted amount.²⁴⁴

By the 1940s the Tax Court had come to flatly stating the rule as follows:

[C]ompensation for services of officers of corporations for any period is subject to modification either by corporate action or by agreement at any time and from time to time during the taxable year and the amount at which compensation is finally adjusted at the close of the taxable year is the amount which the officer must report as compensation or the corporation may deduct as ordinary and necessary business expense.²⁴⁵

The Tax Court has applied this exception to modifications where the payment of compensation was neither in error nor subject to conditions subsequent.²⁴⁶ Similarly, the Service often flatly states the rule to be that

a taxpayer's gross income includes the amount of compensation set forth in a renegotiated employment contract rather than the amount of compensation set forth in an original employment contract where the renegotiated employment contract is bona fide and legally binding on the parties. Furthermore, the Board of Tax Appeals, the Tax Court, and the Service are generally in agreement that the renegotiated employment contract must be executed and the resulting salary adjustments must be implemented prior to the close of the taxpayer's taxable year.²⁴⁷

accounting viewpoint; it seemed to reach the *Merrill* result without even mentioning the claim of right rule or any exception thereto.").

244. See *Stern-Slegman-Prins Co. v. Comm'r*, 79 F.2d 289, 292 (8th Cir. 1935); *Basen Steel Works v. United States*, 52-2 U.S. Tax Cas. (CCH) 9439 (1952).

245. *McEwen v. Comm'r*, 6 T.C. 1018, 1025 (1946) (discussing the holdings in *Stern-Slegman-Prins*, *Russell*, *Fulton*, and *Couch*).

246. *Fender Sales, Inc. v. Comm'r*, 22 T.C.M. (CCH) 550 (1963) ("This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount."), *rev'd on other grounds*, 338 F.2d 924, 929 (9th Cir. 1964) ("[D]ischarge by a corporation of its salary obligations to any [shareholder-employees] ... by the issuance of the corporat[e] capital stock ... [were] payment[s] and realization of income by the [shareholder-employees].").

247. I.R.S. Field Serv. Adv. Mem., 1994 FSA LEXIS 5 (Oct. 18, 1994) (finding, however, that the "contract was *renegotiated prior to the rendering of services* by the minister and ... the renegotiated employment contract was otherwise bona fide and legally binding on the parties") (emphasis added); see also Rev. Rul. 79-311, 1979-2 C.B. 25 ("[A]dvances in the instant case were income to A and B at the time of receipt, they were subject to the deductions for FICA employee tax and withholding for federal income tax. The company was also required to pay the employer's share of FICA tax and the FUTA tax on such wages. In the instant case, neither A nor B performed the services that entitled them to retain the excess commissions, and pursuant to their contractual obligation each

The Service reasoned that,

[w]here both the initial receipt of funds and the repayment of some portion thereof take place in the same year, there cannot very well be a serious question about the overall propriety of excluding the amount so repaid from the taxable income of the party who has thus effectively relinquished or disavowed any claim thereto.²⁴⁸

Crellin's Estate, while technically dealing with rescission,²⁴⁹ holds to the contrary.

When a dividend has been declared and paid, it is income to the recipient shareholder. This is true even if the recipient shareholder immediately restores the amounts he has received to the distributing company pursuant to a prior agreement, by his own initiative, or upon request of the issuing board of directors.²⁵⁰

It in effect looks to whether the recipient of a payment had an absolute or vested right at the time of receipt. *Crellin's Estate* frequently has been cited as a claim of right case.²⁵¹ Other decisions cite it for the broader proposition that the compulsion required for a claim of right deduction demands a showing of "at least the probable validity of the adverse claim to the funds repaid."²⁵² Some reconcile *Crellin's Estate* and *Merrill* by applying the former to dividends and the latter to compensation.²⁵³

repaid the excess commissions to their employer at the termination of their employment. A repaid the excess commissions to the employer in the same year in which A received such commissions. Accordingly, the excess commissions repaid by A were excludable from A's gross income in the year of repayment."); I.R.S. Field Serv. Adv. Mem., 1994 FSA LEXIS 485 (Apr. 5, 1994).

248. I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967) ("This is evident from the 'cash basis' salary adjustment case of Albert W. Ressel [sic], 35 B.T.A. 602 (1937) (Acq. C.B. 1937-1, 22), wherein it was held that the corporate officer concerned had 'actually received' no more than a certain net amount 'as salary' in the taxable year at issue. The transfer of a bona fide demand note in satisfaction of a similar salary adjustment has also been held to have this same result for a cash basis taxpayer. Willis W. Clark, 11 T.C. 675 (1948) (Acq. C.B. 1953-1, 3)."); accord I.R.S. Gen. Couns. Mem. 34,893 (June 1, 1972).

249. *Frelbro* read *Crellin* as a claim of right case. *Frelbro Corp. v. Comm'r*, 315 F.2d 784, 786 n.3 (2d Cir. 1963); accord *Kappel v. United States*, 437 F.2d 1222, 1226 (3d Cir. 1970); *United States v. Simon*, 281 F.2d 520, 525 (6th Cir. 1960) (*Crellin* favoring "stricter interpretation of obligation"); *Drybrough v. Comm'r*, 238 F.2d 735, 740 n.5 (6th Cir. 1956).

250. *Chapman v. Comm'r*, 82 T.C.M. (P-H) 307 (1982); see also *Pahl v. Comm'r*, 67 T.C. 286, 292 (1976).

251. See, e.g., *Drybrough*, 238 F.2d at 740 n.5; I.R.S. Gen. Couns. Mem. 34,893 (June 1, 1972) (considering Rev. Rul. 73-511 and citing *Merrill* and *Crellin's Estate* as both involving income received under a claim of right).

252. *Pike v. Comm'r*, 44 T.C. 787, 799 (1965); see also *Berger v. Comm'r*, 37 T.C. 1026, 1031-32 (1962) (citing *Crellin's Estate* as "much like" the case at hand involving

Under both the rescission in year one and returning compensation authorities, the better view requires an explicit or perhaps implicit condition subsequent which, if it occurs and the parties undo the original transaction putting themselves in the status quo ante, the initial transaction is disregarded for federal income tax purposes.²⁵⁴

As to “retention” bonuses paid in March 2009, the political²⁵⁵ and popular criticism²⁵⁶ was much more widespread than in 2008, and the demand of repayment by the executives soon (certainly before the end of 2009) was explicit.²⁵⁷

I’ve said before that paying excessive bonuses to the same group of folks that helped get us into this crisis is simply unacceptable. Millions

repayment of excess salaries in subsequent year after tax audit determined that excess was unreasonable compensation.). See the discussion from the original *Oswald*, *supra* note 38. On the other hand, I.R.S. Field Serv. Adv. Mem., 1991 FSA LEXIS 4 (Oct. 28, 1991) distinguished a salary repayment before year end from repayment of a dividend before year end.

253. See I.R.S. Field Serv. Adv. Mem., 2001-124-008 (Mar. 14, 2001). “[A] dividend once legally declared by the corporation’s board of directors cannot be revoked.” *Id.* “[Yet] in the same taxable year of receipt a taxpayer realizes that a payment was received in error, an acknowledgment of an obligation to repay prevents the need for recognition.” *Id.* (citing *Merrill*). The rationale is probably that state corporate law may have strict rules as to rescission of a dividend once declared, treating it as vested so that the corporation has no authority to rescind it. See *Crellin’s Estate v. Comm’r*, 203 F.2d 812, 815 (1953) (“[F]or tax purposes, it is that which the holding company could have compelled, not that in which the stockholders were willing to acquiesce, which controls.”).

254. See *supra* note 187 and accompanying text.

255. See, e.g., Chuck O’Toole, *House Vote on AIG Bonus Surtax Imminent*, TAX NOTES TODAY, Mar. 19, 2009, at 51-1 (“H.R. 1586[] would impose a 90 percent [personal] income surtax on [unreturned] employee bonuses, ... define[d] as ‘any retention payment, incentive payment, or other bonus which is in addition to any amount payable to such individual for service performed by such individual at a regular hourly, daily, weekly, monthly, or similar periodic rate.’ The surtax would only apply to employees ... with more than \$250,000 in adjusted gross income ... whose companies have accepted at least \$5 billion from the federal government through Treasury’s Troubled Asset Relief Program [TARP].”); see also News Release, *supra* note 6 (“Senate Finance Committee Chairman Max Baucus (D-Mont.), Ranking Member Chuck Grassley (R-Iowa), Senator Ron Wyden (D-OR), and Senator Olympia Snowe (R-ME) today introduced the Compensation Fairness Act of 2009, legislation to discourage excessive compensation by companies that have taken taxpayer funds, and recoup payments made to executives at recipient institutions of funds from the Troubled Assets Relief Program (TARP). For companies that received TARP funds, the legislation would impose a 35 percent excise tax on both employers and employees, on retention bonuses and other bonuses.”).

256. See *supra* notes 6-9 and accompanying text.

257. See *supra* note 10 and accompanying text.

of Americans continue to struggle to get by, counting their dollars, and Congress needs to do the same. We need to track Federal dollars now more than ever We must act quickly on this proposal—for the sake of the American taxpayer, for the sake of what's right to do. I will work with my colleagues in both the House and Senate to make sure that's what happens.²⁵⁸

For example, House Ways & Means Committee Chair Charles Rangel, D-N.Y., summed up the feelings of many regarding the AIG bonuses during the floor debate on H.R. 1586, taxing Executive Bonuses paid by companies receiving TARP assistance:

Most all Americans believe that a bonus is something that is paid as a reward for a job well done. And certainly we don't believe in the House that when a handful of people receiving taxpayers' money for threatening the community in which we live, and indeed our country and the financial structure of the world, the whole idea that they should be rewarded millions of dollars is repugnant to everything that decent people believe in. But notwithstanding that, it is not our job to tell the private sector what to do; it is our job to say you don't do it at taxpayers' expense.

All this bill does is just pull out that part that they called bonus. And if you received, or the company received, \$5 billion of taxpayers' money, we say the tax that you will pay on this is 90 percent. The rest of your income would be at the regular rate of 35 percent. If, indeed, this combination of the so-called bonus reward is combined with the regular salary and reaches a cap of \$250,000, only the regular 35 percent would count.

Maybe somewhere along the line someone might say, "I don't deserve this, we've caused enough damage, people have lost their jobs, their savings, they've lost their homes, their health insurance, they've lost their dignity, they've lost their pride, and we don't deserve to take this money from the taxpayers." Then give it back, don't receive it, and the law certainly would not apply. But if you're proud of what you've done, we are saying the buck is going to stop here, the red light is

258. News Release, *supra* note 6 (statement of Max Bacus, S. Fin. Comm. Chairman, D-Mont.); see also Brett Ferguson, *Baucus Pledges Action on Bill to Recover Bonuses at Companies Receiving TARP Funds*, DAILY TAX REPORT, Apr. 1, 2009, at G-3 ("Grassley suggested that because many of the employees who received bonuses were not still working at the company, they were improperly labeled as retention bonuses and were, in fact, performance-based pay that guaranteed executives would get the money even though they knew 2008 and 2009 would be unprofitable years."); *id.* ("Senate legislation (S. 651) would impose excise taxes of 70 percent on certain 'excessive executive compensation' at firms receiving TARP funds.... Corporations and individual recipients would each have to pay a 35 percent excise tax on excessive compensation. For nonretention bonuses, such as those for performance or an annual year-end bonus, the same tax rates would apply, but it would apply to all amounts over \$50,000.").

flashing. And anyone thinking about doing this, we say you just pay your dues to the IRS because we're going to be watching this.

Mr. Speaker, we're not trying to punish anybody, we just say do what you have to do. Rewards are subjective, but you don't do it with taxpayers' money.²⁵⁹

c. Deduction vs. Voluntary Repayment

In the context of Section 1341, many cases have held that if the agreement to repay part of compensation was entered into after the year in which the compensation had been paid, no deduction was allowed in year one on the grounds that the repayment was voluntary.²⁶⁰ Similarly, the *Crellin's Estate* line of payback in year one authorities use the term "voluntary" (hence the original payment is not excludible and the repayment is non-deductible) where the original obligation of payment did not contain a condition subsequent and the repayment was instead required by a second contract.²⁶¹ "Voluntary" is shorthand for repayments "which clearly ha[ve] no legitimate business purpose but rather serve[] tax manipulation ends."²⁶² Those cases involved closely held corporations where a suit for performance was unlikely.²⁶³ For example, where a shareholder

259. 155 Cong. Rec. H3656 (daily ed. Mar. 19, 2009) (remarks of Charles Rangel, H. Ways & Means Comm. Chair, D-N.Y.); accord 155 CONG. REC. H4303 (daily ed. Apr. 1, 2009) (remarks of Rep. Melissa Bean, D-Ill.) ("[L]ike many of our colleagues and constituents, we were outraged by bonuses paid to those who brought down AIG and the economy along with it."); *id.* H4276-77 (remarks of Rep. Steve Cohen, D-Tenn.). Misuse of TARP money which was to unfreeze the credit markets included: junkets, bought up baby banks, paying bonuses expressly prohibited by the TARP bill, and counter payments to foreign banks who had bet the subprime mortgages would crater. 155 CONG. REC. H4280 (daily ed. Apr. 1, 2009) (remarks of Rep. Sheila Jackson-Lee, D-Tex.); 155 CONG. REC. H4000 (daily ed. Mar. 25, 2009) (remarks of Rep. Duncan Hunter, R-Cal.); 155 CONG. REC. H4287 (daily ed. Apr. 1, 2009) (remarks of Rep. Alan Grayson, D-Fla.).

260. See I.R.S. Gen. Couns. Mem. 35,484 (Sept. 17, 1973); see also I.R.S. Gen. Couns. Mem. 35,557 (Nov. 8, 1973).

261. *Nat'l Life & Accident Ins. Co. v. United States*, 244 F. Supp. 135, 138 (M.D. Tenn. 1965) (explaining *Grandview Mines v. Comm'r*, 32 T.C. 759 (1959)), *aff'd* 385 F.2d 832 (6th Cir. Tenn. 1967); *Noble v. Comm'r*, 368 F.2d 439, 445 (9th Cir. 1966) ("We find no merit to petitioners' argument that their acts, in the years subsequent to the year in which the payments were made, did not create a new legal relationship. Their attempt to distinguish *United States v. Simon*, *supra*, and *Crellin's Estate v. Commissioner* ... on the basis that in those cases there were new legal relationships is not valid.")

262. *Nat'l Life & Accident*, 244 F.2d at 138.

263. See *Cal-Farm Ins. Co. v. United States*, 647 F. Supp. 1083, 1090 (E.D. Cal. 1986).

and his closely-held corporation cast a transaction as a transfer of corporate assets and upon discovering adverse tax consequences, they recast the transaction as a sale to the shareholder before year end, the Court of Claims held that the parties were not restored to the status quo ante (the shareholder now owned the asset) and rescission was not available.²⁶⁴ The

Plaintiff presents no evidence that it ever sought legal advice concerning a possible legal claim against it by Life. Nor does plaintiff contend that Life ever considered or threatened to bring a lawsuit against it. Instead, plaintiff argues that the payments, though voluntary, were necessary since their primary purpose was to repair or improve business relations, citing *Harold L. Jenkins*, para. 83,667 T.C.M. (P-H)(1983) (taxpayer, country singing star Conway Twitty, voluntarily repaid investors in his failed 'Twitty Burger' venture in order to protect his professional reputation); *M.L. Eakes Co.*, para. 81,429 T.C.M. (P-H)(1981) (taxpayer voluntarily repaid trade creditors of a related corporation in order to obtain credit for itself); *C. Doris H. Pepper*, 36 T.C. 886 (1961) (taxpayer attorneys voluntarily reimbursed parties who had invested in their client's fraudulent scheme in order to protect their firm's reputation); *Snow v. Commissioner*, 31 T.C. 585 (1958) (payments by law partnership to support a savings and loan association which generated legal fees for the firm); *L. Heller and Son, Inc. v. Commissioner*, 12 T.C. 1109 (1949) (payments by jeweler to creditors of bankruptcy subsidiary in order to improve credit-rating). In each of these cases the taxpayers made voluntary payments to third parties when the existence of the obligations threatened existing business relations and the taxpayers' reputations.

The circumstances surrounding the plaintiff's payments to its subsidiary are distinguishable from those in the cited cases. In the cited cases, the taxpayers made payments to *third parties* with whom they dealt at arm's length, whereas in the present case the boards of directors of the two companies are composed of the same persons; thus, plaintiff was essentially repairing business relations with itself.

Id. "In this case, there is no evidence of a legal obligation on the part of plaintiff to repay its subsidiary; instead, the court has already concluded that it was motivated by a subjective belief concerning the necessity of repayment." *Id.* at 1092. Thus, Section 1341 was unavailable.

264. *Blanco v. United States*, 602 F.2d 324 (Ct. Cl. 1979). In *Blanco*, taxpayers sought to "undo a completed transaction within the same taxable year in order to avoid the originally unforeseen tax consequences of that transaction." *Id.* at 324. The court found that the facts did not support the taxpayers' claim that they rescinded the transaction at issue. *Id.* at 327. In "a rescission, the parties are restored to their respective positions prior to the transaction. That was not done in this case." *Id.* The court noted that "a taxpayer may not reopen and alter a transaction that was valid and complete for business purposes in order to obtain more favorable tax treatment, even though initially he could have cast the transaction in the altered mold." *Id.* "Although in the second transaction the taxpayer issued a note in order to recast the first transaction as a sale of assets, the second

Tax Court has held that where a payback agreement is entered into after payment is made, Section 1341 is unavailable: "[A] restoration agreement voluntarily executed after an item has been received does not establish that the 'taxpayer did not have an unrestricted right to such item.'"²⁶⁵ The Service has, on occasion, distinguished claim of right payback from Section 162 payback, but usually has not.²⁶⁶

The better analysis is that even a voluntary payment by an employee may be deductible as an ordinary and necessary business expense of being a corporate executive²⁶⁷ if his or her intent is to "prevent injury to the taxpayer's business reputation"²⁶⁸ or preserve his or her job.²⁶⁹ "It is now

transaction was not designed to accomplish a sale of assets. The sale was merely the means of achieving the admitted end of avoiding taxation." *Id.* at 328.

265. *Pahl v. Comm'r*, 67 T.C. 286, 291 (1976).

According to the circumstances, terms, and conditions of the original payments of director's fees to petitioner, petitioner was never obligated at any time to return any portion of said fees to the corporation. It was only after petitioner received the director's fees that he voluntarily entered into the repayment contract which may or may not have been binding upon him. However, the fact that the contract may have been binding upon petitioner does not change the essentially voluntary nature of his decision to enter into it. Since a restoration agreement voluntarily executed after an item has been received does not establish that the 'taxpayer did not have an unrestricted right to such item' within the meaning of section 1341(a), that section will not support a 1972 section 165 loss deduction for the amounts repaid by petitioner.

Id. at 290-91.

266. *See Oswald v. Comm'r, action on dec.*, No. 6301-66, 1968 AOD LEXIS 327 (Aug. 20, 1968). *But see* I.R.S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967) ("It has long been recognized that any party who restores funds that he initially received and held under a claim of right will thereby become entitled to take a business expense deduction for the year in which the repayment transaction is actually carried out.... Also directly pertinent here is Rev. Rul. 64-224, C.B. 1964-2, 52 whereby the Service has expressly conceded the deductibility, as ordinary and necessary business expenses, of all amounts which convicted violators of the Sherman Anti-Trust Act pay or incur in satisfaction of private claims for treble damages under section 4 of the Clayton Act.").

267. Being an employee constitutes a trade or business for Section 162(a), separate and apart from the performance of services for an existing employer and rather than, or in addition to, the trade or business of holding a particular job. *See Primuth v. Comm'r*, 54 T.C. 374, 377 (1970) (trade or business of being corporate executive or manager), *acq. in result*, 1972-2 C.B. 2; Rev. Rul. 75-120, 1975-1 C.B. 55 (considered in I.R.S. Gen. Couns. Mem. 35,919 (July 29, 1974)).

268. *Mitchell v. Comm'r*, 73 F.3d 628, 631 (6th Cir. 1996) (holding payment was clearly a stock acquisition cost and hence had to be capitalized).

269. *Gould v. Comm'r*, 64 T.C. 132, 136 (1975).

well-settled that voluntary expenditures that are made to preserve or protect one's business reputation are deductible."²⁷⁰

It has been held that a voluntary payment is not deductible as an ordinary and necessary expense. Nevertheless, the courts ... have often supported the general proposition that voluntary expenditures may qualify as ordinary and necessary business expenses if they are made to prevent injury to the taxpayer's business, or to preserve and protect the goodwill of the business. The Service has stated that voluntary expenditures made to protect, promote, and preserve one's business are deductible as ordinary and necessary business expenses.

....

Deductible voluntary expenditures can be made to protect the taxpayer's general business or commercial reputation, or they can be made to protect the taxpayer's goodwill among its creditors, and customers. The expenditures however, must be made to *preserve* goodwill, since expenditures made to *acquire* goodwill are capital expenditures.... Moreover, on occasion the Service has argued the purported expenditures were really gifts.

Although we agree with the general legal proposition that expenditures to preserve goodwill are deductible business expenses, we also note the courts have required a showing that the expenditures were likely or necessary to preserve goodwill.²⁷¹

Although members of Congress²⁷² and the then CEO of AIG²⁷³ want to refer to repayments of bonuses by executives as giving back the bonuses, they clearly were not voluntary in the sense of non-business. The House

270. I.R.S. Gen. Couns. Mem. 37,649 (Aug. 25, 1978) (citing sources).

271. I.R.S. Gen. Couns. Mem. 36,560 (Jan. 21, 1976) (citations omitted); *see also* I.R.S. Gen. Couns. Mem. 37,384 (Jan. 19, 1978).

272. *See supra* note 259 and accompanying text; *see also* 155 Cong. Rec. H3659 (daily ed. Mar. 19, 2009) (remarks of Rep. Danny Davis, D-Ill.) ("[W]here I live on Main Street in America, if you get something that you didn't deserve, or if you get something that was unwarranted, you either give it back or it's taken back. It's my position that these bonuses were unwarranted, not deserved. If they are not going to give them back, then we are going to take them back."); *id.* at H3664 (daily ed. Mar. 19, 2009) (remarks of Rep. Sheila Jackson-Lee, D-Tex.) ("I rise today with pitchfork in hand to take back from the executives at AIG, monies that rightfully belong to the taxpayers of this country.... Edward M. Liddy, the chief executive of AIG-selected in consultation with the Treasury Department after the first large infusion of government assistance-testified before a House Financial Services subcommittee that he has called on employees who received in excess of \$100,000 to give back at least half of their bonuses, but which he also said are a legal obligation of the company.").

273. *House AIG Hearing*, *supra* note 4, at 54 (statement of Edward Liddy, CEO, AIG) ("I have asked those who received retention payments in excess of \$100,000 or more to return at least half of those payments. Some have already stepped forward and offered to give up 100 percent of their payments.").

Bill refers to “waiver or return of payments.”²⁷⁴ “Asked if the [House] legislation [taxing at 90% unreturned bonuses paid to executives by TARP beneficiaries] had its intended effect, House Ways and Means Committee Chairman Charles Rangel (D-N.Y.) said, ‘Do you think they would have done this voluntarily? Come on.’”²⁷⁵ In short, an AIG executive would be repaying the 2009 bonus to preserve his or her business reputation and, hence, could deduct the repayment as an employee business expense.

What if the AIG executive pays back the “retention” bonus after he has left AIG? If the employee, shortly after leaving AIG, becomes an employee with similar duties in another firm, then the repayment also would be deductible as an ordinary and necessary expense of protecting his or her existing reputation as a corporate executive.²⁷⁶ Similarly, the payment

274. Taxing Executive Bonuses Paid By Companies Receiving TARP Assistance, H.R. 1586, 111th Cong. (2009).

Waiver or return of payments. Such term shall not include any amount if the employee irrevocably waives the employee’s entitlement to such payment, or the employee returns such payment to the employer, before the close of the taxable year in which such payment is due. The preceding sentence shall not apply if the employee receives any benefit from the employer in connection with the waiver or return of such payment.

Id. § 1(b)(2)(C).

275. Heather M. Rothman & Brett Ferguson, *Executive Compensation Punitive Bonus Tax Bill on Back Burner As Some Money Returned, Lawmakers Say*, DAILY TAX REPORT (BNA) No. 55 at G-1 (Mar. 25, 2009); 155 Cong. Rec. H3656 (daily ed. Mar. 19, 2009) (remarks of Charles Rangel, Chair H.Comm. Ways & Means, D-N.Y.) (“At the end of the day, I do hope that this will be a message that will be sent in a bipartisan way. We may have differences in how we resolve this problem in the future, but this problem is there, and we are saying to the IRS and to the commissioner that we really want to make certain that, at the end of the day, they’re not the ones that caused the problem and then get rewarded for it.”); *id.* at H3659 (Remarks of Rep. Bob Etheridge, D-N.C., Member, H. Comm. on Ways and Means) (“If AIG will not halt these bonuses, and if its employees will not voluntarily turn them down, then this bill will ensure that the money is returned to the taxpayers. I regret having to use the tax code in this manner, but the blatant abuse of taxpayer dollars by AIG leaves us with no other choice. This bill will send a message not only to AIG, but to other companies receiving taxpayer aid that this behavior is unacceptable.”); *see also* 155 Cong. Rec. H4264-65 (daily ed. Apr. 1, 2009) (remarks of Rep. Roy Blunt, R-Mo.) Congress sent a message with the bonus claw back legislation. “[T]he AIG executives apparently got the message, because many of them have returned the bonus money back to the taxpayers.” *Id.*

276. *Cf. Gerhard v. Comm’r*, 29 T.C.M. (CCH) 1153 (1970). A taxpayer terminated his employment as general manager with a North Carolina firm on January 18, 1967. *Id.* At some time prior to February 27, 1967, he moved from North Carolina to Wisconsin, where he obtained employment with another firm as controller. *Id.* The Service allowed a deduction for taxpayer’s payment of \$52 in March 1967 to an employment agency under Revenue Ruling 60-223, 1960-1 C.B. 57. *Id.*

would be deductible if paid during a short (e.g., not more than one year) “hiatus” during which the former employee is unemployed but is still actively seeking employment in a job in the same trade or business.²⁷⁷ Judge Tannenwald stated in his concurring opinion in *Primuth v. Commissioner* that “[i]n cases of the instant type, I would adopt the simple test of comparing the position which the taxpayer occupied before and after the change. Perhaps the categorization of corporate executive will not always be applicable, but, in this case, petitioner was at all times a *financial* corporate executive.”²⁷⁸

The Tax Court in one of the *Primuth* progeny elaborated that “[i]f substantial differences exist in the tasks and activities of various occupations or employments, then each such occupation or employment constitutes a separate trade or business.”²⁷⁹ Furthermore, “the Tax Court has adopted a ‘commonsense’ or functional approach, holding that whenever additional licenses, new skills or more discretionary responsibilities are required in the new employment, a taxpayer has entered a new trade or business.”²⁸⁰

The deductible education cost regulation²⁸¹ has been a useful rule of thumb in making this determination.

277. Rev. Rul. 75-120, 1975-1 C.B. 55; *see also* *Primuth v. Comm’r*, 54 T.C. 374, 378 (1970) (“[I]t is possible for an employee to retain, at least temporarily, his status of carrying on his own trade or business independent of receiving any compensation from a particular employer.”); *cf.* *Ford v. Comm’r*, 56 T.C. 1300, 1306-07 (1971) (education costs), *aff’d per curiam*, 487 F.2d 1025 (9th Cir. 1973); *Furner v. Comm’r*, 393 F.2d 292 (7th Cir. 1968) (same). The Tax Court has found hiatus periods of even longer than a year to be temporary. *See* *Haft v. Comm’r*, 40 T.C. 2 (1963) (four years); *Hitt v. Comm’r*, 37 T.C.M. (CCH) 333 (1978) (three years); *Sherman v. Comm’r*, 36 T.C.M. (CCH) 1191 (1977) (two years).

278. *Primuth*, 54 T.C. at 382.

279. *Davis v. Comm’r*, 65 T.C. 1014, 1019 (1976).

280. I.R.S. Gen. Couns. Mem. 37,320 (Nov. 14, 1977). The Second Circuit described the Tax Court as insisting “on a high degree of identity in deciding the issue of sameness.” *Estate of Rockefeller v. Comm’r*, 762 F.2d 264, 268 (2d Cir. 1985).

281. Treas. Reg. § 1.162-5(b)(3) (2009).

(3) Qualification for new trade or business. (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual’s present employment. For this purpose, all teaching and related duties shall be considered to involve the same general type of work.

That regulation, adopted to test the deductibility of educational expenses, provides in relevant part that in the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment.²⁸²

The harder question is whether an executive returning the bonus and quitting employment with AIG, who is now self-employed and not looking for a similar job with another firm, may deduct the repayment to the TARP benefitted firm. At first blush, this is the classic *Welch v. Helvering*²⁸³ fact pattern. There, the taxpayer paid portions of claims discharged in the bankruptcy of a corporation in order to re-establish business relations with the corporation's former customers who had held those claims, whom he had known when acting for the corporation, and for whom he now sought individually to purchase from him on a commission in order to "solidify his credit and standing."²⁸⁴ The Court held that the payments to the creditors were necessary for the "development" of the taxpayer's business but "[m]any necessary payments are charges upon capital."²⁸⁵

Reputation and learning are akin to capital assets, like the good will of an old partnership.... For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well

Id.

282. I.R.S. Gen. Couns. Mem. 35,919 (July 29, 1974) (considering Rev. Rul. 75-120, 1975-1 C.B. 55); see also *Estate of Rockefeller*, 762 F.2d at 268 & n.5 ("The Tax Court, with the approval of the courts of appeals, has limited deductibility to cases where the taxpayer was seeking employment in the *same* trade or business. Moreover, the courts have insisted on a high degree of identity in deciding the issue of sameness.... Most of these cases concerned education expenses, as to which there is a regulation, Treas. Reg. § 1.162-5 (1960). This elaborates on the statute by defining a specific type of deductible expenses, § 1.162-5(a)(2), and by prohibiting the deduction of expenses incurred in order to attain minimum educational requirements for a position, § 1.162-5(b)(2), and expenses for a program of study leading to qualification in a new trade or business, § 1.162-5(b)(3). However, the Tax Court cites education cases in decisions regarding other types of expenses incurred in obtaining a new position."). "If substantial differences exist in the tasks and activities of various occupations or employments, then each such occupation or employment constitutes a separate trade or business." *Davis*, 65 T.C. at 1019. I.R.S. Gen. Couns. Mem. 37,320 (Nov. 14, 1977) (considering Rev. Rul. 78-93, 1978-1 C.B. 38) ("Section 1.162-5(b)(3) of the regulations further provides that a change of duties does not constitute a new trade or business if the new duties involve the same general type or work as is involved in the taxpayer's present employment.").

283. 290 U.S. 111 (1933).

284. *Id.* at 112.

285. *Id.* at 113.

and wisely spent. It is not an ordinary expense of the operation of a business.²⁸⁶

*Conti v. Commissioner*²⁸⁷ shows that the key issue in this context is “drawing a line between expenditures to preserve and protect business reputation and those which improve and develop good will.”²⁸⁸ At the time of *Welch*, courts were just beginning to hold that a corporate executive could be in a trade or business of being an employee as to deductible expenditures.²⁸⁹ Even almost four decades after *Welch*, the conventional wisdom was that a corporate executive’s trade or business was limited to performing services just for his or her present employer.²⁹⁰ As discussed above, that rigid line was erased by *Primuth*.²⁹¹ The focus became whether the taxpayer was seeking the general type or work as was involved in his or her present employment with no additional skill or training needed and no substantial differences in the tasks and activities.²⁹² Employment and self-employment meeting such continuity should be a continuation of the same trade or business and thus support current deduction of expenditures incurred to preserve the former executive’s business reputation, even where he or she is now self-employed. One can easily imagine the question of job-seeking expenditures incurred by a terminated senior associate who ends up self-employed (and perhaps taking a portfolio of clients with him).

Assuming that the bonus repayments are deductible by former executives, the problems just begin. The tax results of a deduction are not

286. *Id.* at 115-16.

287. 31 T.C.M. (CCH) 348 (1972).

288. *Id.* (“[W]e hold that petitioner’s expenditure of \$488,464.89 in 1964 was proximately related to his business activities and was made to preserve and protect his business reputation in order to enable him to continue to carry on such activities.... Consequently, he is entitled to a deduction in that amount under section 162(a).”).

289. The early history of this principle is ably recounted in the landmark case, *Trent v. Comm’r*, 291 F.2d 669, 671-75 (2d Cir. 1961).

290. *Primuth v. Comm’r*, 54 T.C. 374, 384 (1970) (Tietjens, J., dissenting) (“I would say the taxpayer was in the business of being an employee of Foundry when the claimed deductible expenses were incurred. The expenses, however, were not *related* to his employment by Foundry but were paid to obtain a new job with *another* employer. To me this is the same as incurring expenses in locating or finding a new business.”); I.R.S. Gen. Couns. Mem. 35,919 (July 29, 1974) (considering Rev. Rul. 75-120, 1975-1 C.B. 55) (“[T]he long standing position of the Service has been that expenses incurred by employees in seeking and actually securing new employment are deductible as ordinary and necessary business expenses, but that expenses incurred in seeking but not securing new employment are not deductible.”).

291. *See supra* note 278.

292. *See supra* notes 279-82 and accompanying text.

comparable to rescission of the bonus and return to the status quo ante or year end netting described above, as to the former executive who remains in employee status seeking another executive position or is employed as an executive by a different employer. The repayment would constitute a “miscellaneous itemized deduction” which is reduced by an amount equal to 2% of AGI²⁹³ and which would be greatly increased by the retention bonus. A substantial repayment deduction would impact the phase-out of itemized deductions in general, of which the repayment deduction would surely be the greatest, (roughly by one third of 2% of AGI above a comparatively low floor for 2009,²⁹⁴ and the phase-out of personal exemptions under Section 151.) That is just on the income tax side. The heavy impact would be under the Alternative Minimum Tax since no “miscellaneous itemized deduction” is a deduction in computing alternative minimum taxable income.²⁹⁵ Thus, the bonus would be included in alternative minimum taxable income for 2009, but the 2009 repayment would not be deductible. The AMT rate for most of these executives would probably be 28%.²⁹⁶ Finally it does not appear that the repayment would reduce the wages subject to the Medicare tax.

CONCLUSION

As discussed above,²⁹⁷ the ideal solutions are for Congress and the Service to specifically address repayment of retention bonuses to TARP recipients in the year of receipt of the retention bonus, or in the subsequent year—with rescission in the first case and a Section 1341 deduction in the second. Such solutions should be expressly based on the controversy at the time of payment of the bonus so that it was not received under an absolute claim of right, but instead was subject to a condition subsequent. Because this has not been done promptly, only a handful of AIG Financial Products executives in the top twenty five of AIG employees remain who have made the repayment pledge.²⁹⁸ So who is the sucker now? Arguably those who made the pledge are suckers, not because the original retention bonus, to the extent repaid, is not excludible in 2009 nor deductible under section 1341 if the retention bonus was paid in 2008, but because most of their colleagues

293. I.R.C. § 67 (2006).

294. *Id.* § 68.

295. *Id.* § 56(b)(1)(a)(i).

296. *Id.* § 55(b)(1)(A)(i).

297. *See supra* notes 39–40 and accompanying text.

298. *See supra* note 18.

who made the pledge kept the money and ran. The even bigger suckers are members of Congress who believed the problem was solved by the pledges.

What is to be done now? Neither Congress nor the Service addressed the retention bonuses in 2009. But the problem has not gone away, "AIG is scheduled to pay out an additional \$198 million to employees in March [2010]."²⁹⁹ Pay Tsar, Feinberg's *Proposed Compensation Payments and Structures* would preclude payment of any 2009 retention bonus in 2010 to AIG's Financial Products employees.³⁰⁰ AIG Financial Products executives, however, are threatening to leave en masse if they do not receive their retention bonuses in March 2010.³⁰¹ Europe may not be a haven for such traders since England plans to force banks to pay a 50% tax on bonuses above \$40,700³⁰² with France and Germany likely to follow suit.³⁰³ Havens with other financial institutions should be reviewed as well.

Goldman Sachs is reported to have said that its top executives will forgo cash bonuses, instead being paid in long-term stock.³⁰⁴ Furthermore, the Federal Reserve, contemporaneous with the Pay Tsar's proposals, proposed principles designed to discourage pay packages that may encourage risky practices.³⁰⁵ If financial institutions fail to promptly adopt pay

299. See Dennis, *supra* note 18.

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

301. See Sherman, *supra* note 18; Florence Olsen, *Rep. Frank Previews Issues for Jan. 22 Hearing on Financial Industry Pay*, 8 DAILY TAX REP. GG-2 (Jan. 14, 2010).

The hearing will examine arguments made by the financial services industry that regulating compensation will cause an exodus of valuable employees from the financial services industry to other U.S. industries or to foreign companies. "It's time to get those arguments aired," Frank said. "There may be, in some of these financial institutions, people capable of playing major league baseball, but I'm not aware of any," he added. "But absent that, I don't know where they would go to get comparable forms of compensation."

Id.

302. Landon Thomas, *Executive at Barclays Defends Pay*, N.Y. TIMES, Dec. 19, 2009; David Jolly, *France Confident it Can Tax and Retain Bankers*, N.Y. TIMES, Jan. 13, 2010, <http://www.nytimes.com/2010/01/13/business/global/13bonus.html>; Gaelle Faure & Henry Chu, *France Plans Tax on Bank Bonuses*, L.A. TIMES, Dec. 17, 2009, at A-38; David Francis, *Obama Can Put Brakes on Big Bank Bonuses*, CHRISTIAN SCI. MONITOR (Jan. 18, 2010) (discussing how France and Britain have moved to tax 2009 bank bonuses); Rick Mitcheli, *Lagarde Says France Expects Bonus Tax on Bankers to Raise 360 Million Euros*, 7 DAILY TAX REP. I-2 (Jan. 13, 2010).

303. Louise Story, *Goldman Sachs Bars Cash Bonus For Top Officers*, N.Y. TIMES, Dec. 11, 2009, at Bus. A1; Editorial, *Taming the Fat Cats*, N.Y. TIMES, Dec. 20, 2009, at A6.

304. *Id.*

305. Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg.

structures along these lines, Congress should either force their adoption or impose a hefty excise tax on large cash bonuses.

The time is ripe. In a Time Magazine poll conducted shortly after Goldman announced its blockbuster bonuses, only 18% of respondents thought “large Wall Street financial institutions learned from their mistakes,” while a whopping 75% believed that “business as usual” would prevail.³⁰⁶ More ominously for Goldman, 62% of respondents said the government should strictly limit pay at Wall Street firms, “regardless of whether or not they’ve paid back the government.”³⁰⁷ As the New York Times reported, Wall Street pay is a focus of many in Washington and “[t]he Obama administration wants to tax it. The Federal Reserve wants to tweak it. And the Federal Deposit Insurance Corporation wants to shape it.”³⁰⁸

55,227, 55,231 (proposed Oct. 27, 2009)

To be consistent with safety and soundness, incentive compensation arrangements at a banking organization should: Provide employees incentives that do not encourage excessive risk-taking beyond the organization’s ability to effectively identify and manage risk; Be compatible with effective controls and risk management; and Be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Id.

306. John Paul Rollert, *Goldman Sachs Bonuses: More than Just Bad PR*, CHRISTIAN SCI. MONITOR (Dec. 18, 2009); *October 26-27 Survey*, TIME MAG., available at www.srbi.com/Wall%20Street%20Questionnaire%29Poll%20Results.pdf.

307. See *October 26-27 Survey*, *supra* note 306.

308. Eric Dash, *Wall St. Pay is a Focus of Many in Washington*, N.Y. TIMES, Jan. 13, 2010, at B-1. At this time the Obama Administration was reluctant to tax the banking executives directly on their bonuses, but preferred instead to tax the big banks directly on risks that they are taking by subtracting from total assets common stock and FDIC insured deposits (with the hoped for results that these banks will reduce bonuses and lend the savings to borrowers to reduce risks and the tax). Cheryl Bolen & Jay S. Heflin, *Obama Unveils New Tax on Banks to Mitigate “Excesses” of Wall Street*, 9 DAILY TAX REP. GG-3 (Jan. 15, 2009); Jay S. Heflin, *Frank Backs Idea of Bank Penalty*, 7 DAILY TAX REP. G-5 (Jan. 13, 2010).