

Untaxingly Yours

The Tax Impact of Repaying a Signing Bonus

By Brian T. Whitlock

Over four million people quit their jobs in the United States in each of the last five months of 2021.¹ The popular press has referred to this phenomenon as “The Great Resignation”.² The reason for the massive number of people quitting was not a desire to retire from the work force, but instead it was based on working conditions, job frustration, burnout, and the realization that better job opportunities existed elsewhere in the labor market.

As employers began to compete for this potential pool of freshly available workers, the moniker of “The Great Resignation” quickly became replaced with the phrase “The Great Job Migration”.³ Hotel and restaurant workers left the hospitality industry creating shortages in their wake. Teachers left the classroom and returned to corporate America in droves. A feeding frenzy ensued as employers saw an opportunity to upgrade their employee talent. Competition among potential employers for workers increased, salaries rose, and signing bonuses were offered to all sorts of new hires in not only the service industry but also in the executive suite. As a condition to accepting significant signing bonuses (sometimes over \$100,000), workers were frequently required to agree in writing to repay the signing bonus, if they quit their new job within the first few months.

This column will focus on the income and payroll tax implications of signing bonuses, especially focusing on the tax implications on the employee of repaying the signing bonus. Among the questions to be addressed: Are employers required to amend payroll tax returns and wage statements? How should employers and employees treat the repayment for income tax purposes? What happens when the repayment occurs in a subsequent calendar year?

I. Employer Treatment of Signing Bonuses

When a signing bonus is paid to an employee (whether it is paid in cash or in kind), it is required to be included in the employee's income. The employer is required to withhold federal and state income taxes, social security tax, and Medicare tax. The employer will include this information in its quarterly payroll tax filings, and the employer will issue an Internal Revenue Service (IRS) Form W-2 to the employee at the year end.

If the employee terminates and is forced to repay the bonus within the calendar year, the employer must include the recovery in income or reduce the applicable

expense. If the recovery occurs early enough in the calendar year, the employer may voluntarily adjust or amend one or more of their quarterly payroll tax filings within the calendar year and recoup the payroll taxes that they deposited,⁴ thus only requiring the employee to repay the net amount of the bonus.

If the employee terminates late in the year or in the subsequent calendar year and the repayment occurs after year end, then the employer's solution is more complicated. The employer would need to amend the quarterly payroll tax return and file a corrected IRS Form W-2c in order to remedy the situation perfectly. This is not an easy solution, as many tax preparers witnessed over the past two years with the filing of amended payroll tax returns (IRS Form 941c) and claims for the Employee Retention Credit in 2020 and 2021, there have been long delays in the processing of paper tax returns by the Internal Revenue Service in 2021 and 2022.

The Right of Claim Doctrine is a rule that governs the timing and recognition of income. When events occur that throw that timing off, or place what should otherwise be offsetting events in different tax period, the Right of Claim Doctrine intervene in order to "right the ship" and return taxpayers to an equal footing where payments made to reimburse an expense or restore a capital loss can be properly offset and rendered tax neutral.

As a result of COVID-19, many IRS workers were permitted to work remotely. Hundreds of thousands of amended payroll tax returns requesting tax refunds, which were filed in June of 2020, remain unprocessed at the IRS Service Centers. On January 26, 2022, Forbes Magazine⁵ reported that a letter sent by over 200 members of the U.S. House of Representatives asserted that there are nearly 500,000 amended Forms 941 that remain to be processed. The IRS has acknowledged repeatedly that a "paper crisis" currently exists at the Service Centers. Refund requests

and taxpayer correspondence go unanswered while the IRS computers continue to churn out past due collection notices and demands for penalties and interest on payments. The bottom line is that the process for the employer can be time consuming and uncomfortable. As a result, most employers refuse to take corrective payroll action for late-year terminations.

If the taxpayer is forced to repay the gross bonus and the employer refuses to file amended quarterly payroll tax returns for the prior year and issue a corrected IRS Form W-2c, then the tax reporting burden will fall solely on the shoulders of the former employee. If the facts surrounding employee's termination are unpleasant, there may in fact be additional resistance on the part of the former employer to render voluntary aid to the former employee. Remember, there is no statutory requirement on the part of the employer to assume the burden of filing adjusted or amended payroll tax returns and corrected IRS Forms W-2c, so threats and complaints will be summarily discarded.

If your client is the employee and looking for a persuasive argument, check the repayment agreement. If the agreement does not require the employee to reimburse the employer for the gross amount of the bonus, plus the employer's portion of the payroll taxes paid on the bonus, then the employer may suffer an economic loss by refusing to amend payroll tax returns and file a corrected IRS Form W-2c. Suggesting that the employer could avoid an economic loss might be persuasive.

II. Employee Reporting of Repayments

If the repayment of the signing bonus occurs in the same calendar year as the payment, but the employer refuses to correct the payroll tax reports, then the employee may claim an income tax deduction equal to the amount repaid and receive the benefit of federal and state income taxes that were withheld on their current return.

If the repayment occurs in a subsequent tax year and the employer refuses to issue a corrected W-2c to the employee, then the employee can either claim an income tax deduction or an income tax credit on the individual income tax return covering the year of the repayment.

III. Claim of Right—Deduction

A deduction is allowable in the year of repayment under Code Sec. 1341(a) for the taxable year in which the item was included in gross income, if it was established after the close of the taxable year that the taxpayer did not have

an unrestricted right to the item, and the amount of the deduction exceeds \$3000.⁶ If the amount is repaid in the same calendar year and the employer does not readjust their payroll returns or the taxpayer's IRS Form W-2, then the taxpayer may deduct the amount of the repayment as a business deduction (without and limitation or reduction).⁷ So, where does the individual taxpayer deduct the repayment?

Recall that changes made by the Tax Cuts and Jobs Act (TCJA) have eliminated employee business expenses as IRS Form 1040, Schedule A—*miscellaneous itemized deductions*. A “below the line”⁸ deduction would not have been favorable, even if it was available, because it would not likely reduce your state income taxes, if your state's computation of taxable income begins with Federal Adjusted Gross Income (AGI).

If you choose to claim a deduction under Code Sec. 1341, then it should be categorized as a “business deduction” and claimed “above the line.” In order to claim the amount of the payment above the line, you would need to claim the deduction in one of the three places Schedule C, Schedule E, or on Form 2106, Part I, line 4 where it would ultimately flow through to Schedule 1 (Form 1040), line 12. The instructions for Form 2106 do not contemplate this form being used by ordinary employees; nevertheless, this writer believes that is where the “business deduction” fits best. The deduction is claimed in the tax year in which the payment is made. If the repayment year is a year subsequent to the year of inclusion, then the income tax return for the year of inclusion remains unchanged.

The disadvantage of claiming the Code Sec. 1341 deduction is that the social security and Medicare taxes withheld by the employer will be lost. They may help influence your Social Security work record and thus your benefit at retirement, but that is a long way off into the future. Even if the taxpayer reimbursed the employer for the gross amount of the bonus, the value of the tax deduction that would include the social security and Medicare taxes repaid will not offset the full dollar amount of the

employee's portion of the payroll taxes that were repaid to the employer.

IV. Claim of Right—Credit

If the repayment occurs in the subsequent tax year, the employee may claim a tax credit under Code Sec. 1341 instead of a business deduction for the amount of the repayment. If a credit is claimed, the income tax return for the year of the income inclusion is not reopened.

If the taxpayer chooses to claim the credit rather than the deduction, the taxpayer recomputes the actual prior year taxes paid on bonus (using a “with and without” calculation). This computation will yield the amount of tax paid in the prior year and thus the tax credit that may be claimed by the taxpayer on the subsequent year return covering the year of repayment. Reg. §1.1341-1(d)(3) and (4)⁹ contain numerous examples on how to compute the tax credit. The benefit of the credit over the deduction is that it relieves any inequity that may be caused if there are changes in the taxpayer's tax rate from year to year. It should also be noted that a similar tax credit computation may be made in order to claim a state income tax credit relative to the amount of the repayment.

V. Right of Claim—Generally

Right of Claim and Code Sec. 1341 have broad application and are not merely limited to employment issues. The Right of Claim Doctrine is a rule that governs the timing and recognition of income. When events occur that throw that timing off, or place what should otherwise be offsetting events in different tax periods, the Right of Claim Doctrine intervenes in order to “right the ship” and return taxpayers to an equal footing where payments made to reimburse an expense or restore a capital loss can be properly offset and rendered tax neutral.

ENDNOTES

¹ “Economic News Release, Table 4—Quits levels and rates by industry and region, seasonally adjusted”, Bureau of Labor Statistics, www.bls.gov/new.release/jolts.t04.htm (last modified: February 1, 2022).

² Meg Embry, The Best Schools, www.thebest-schools.org/careers/career-prep/the-great-job-migration (September 26, 2021).

³ Josh Bersin, www.joshbersin.com/2021/12/from-the-great-resignation-to-the-great-migration (December 5, 2021).

⁴ If the employer adjusts the quarterly payroll taxes returns, then the bonus payment could be omitted from the employee's IRS Form W-2.

⁵ Amber Gray-Fenner, *Under Pressure from Congress IRS Offers Taxpayers Limited Relief*, *Advocacy Coalition Pushes Back*, FORBES (January 28, 2022).

⁶ Code Sec. 1341(a), Public Law 87-863 (1962).

⁷ Even if it is determined that Code Sec. 1341 does not apply, the Service has ruled that the employee may still claim a business deduction under Code Sec. 162 for the amount repaid in that year if the original receipt was included in

the employee's gross income. Rev. Rul. 69-115, 1969-1 CB 50 (January 1, 1969).

⁸ “Below the line” is a colloquial reference to IRS Form 1040—Schedule A “*itemized deductions*” and other deductions occurring after the computation of Adjusted Gross Income (AGI).

⁹ Reg. §1.1341, T.D. 6242, 1957-2 CB 592 (July 19, 1957). Amended by T.D. 6617, 1962-2 CB 196, 11-6-62; T.D. 6747, 1964-2 CB 326, 7-20-64; T.D. 7244, 1973-1 CB 395, 12-29-72; T.D. 7564, 1978-2 CB 19, 9-11-78; and T.D. 8677, 1996-2 CB 119, 6-26-96.

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