A Tax Audible: Coaches and Buyouts

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I. INTRODUCTION

After Mack Brown resigned,[1] the University of Texas ("Texas") looked to hire a new head football coach for its premier college football program. The school set its eyes on Charlie Strong, head football coach for the University of Louisville. For Texas to successfully hire Strong, his contract required a buyout payment from Strong to the University of Louisville for $4.375 million.[2]

In the world of athletics, this situation was not unusual:[3] typically, the new university employer reimbursed the coach for the

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1. At the time, it was reported that the President of the University forced Mack Brown to resign. *See* Pat Forde, *Source: Mack Brown Forced out as Texas Coach After President Withdrew Support*, YAHOO! (Dec. 23, 2013), *available at* http://sports.yahoo.com/news/source--mack-brown-forced-out-as-texas-coach-after-president-withdrew-support-005700558.html, *archived at* http://perma.cc/8UPN-BPK6 (last visited March 10, 2015 at 1:17 PM) ("[T]he 16-year Mack Brown Era at Texas was terminated not by the coach himself, but at the insistence of an embattled school president.").

2. *See* Steve Berkowitz, *Schools Buying Coach's Contracts Instead of Buying Out,* USA TODAY (Nov. 19, 2014), *available at* http://www.usatoday.com/story/sports/ncaaf/2014/11/19/college-football-coaches-compensation-buyouts-texas-louisville-alabama/19271987/, *archived at* http://perma.cc/5NY4-35JE (last visited March 10, 2015 at 1:20 PM) (describing the buyout of Charlie Strong's contract with Louisville).

3. *See* Douglas A. Kahn & Jeffrey H. Kahn, *Will the Tax Man Cometh to Coach Rodriguez*, 120 TAX NOTES 474 (2008) (describing the highly publicized move of Coach Richard Rodriguez from West Virginia University to the University of Michigan).

buyout or directly paid the buyout to the old university employer. Under either arrangement many schools took the position that such payments, whether made directly or as a reimbursement, were includible in the coach's income for federal tax purposes.[4]

The University of Texas, however, accomplished its desired result (hiring Strong as head football coach) in a seemingly unusual manner. Technically, no buyout payment was made. Instead, Texas, with the approval of Strong, purchased the rights to Strong's employment contract from the University of Louisville.[5] Texas claimed that no buyout payment was ever made because the contract was never bought out. Instead, Texas became Strong's employer and then the two parties renegotiated Strong's employment contract.[6] The purchase price of the employment contract was exactly the same as the contractual buyout payment—$4.375 million.[7] This was no coincidence and demonstrated that the true purpose of the payment was to "avoid taxes for coaches and schools."[8]

This Essay explains that such arrangements do not improve the prospects for excluding the payment from the coach's taxable income. The taxation issue applies uniformly in a buyout, regardless of whether (i) the new university employer provides a direct payment, (ii) the new university employer reimburses the coach, or (iii) as the University of Texas recently did, the new university employer buys the employment contract from the old university employer. The substance of all three arrangements is identical. This does not lead to the conclusion that the buyout payment is taxable to the coach, however. Instead, as discussed in Part IV, there are two independent policy justifications that counsel against taxing the coach—regardless of which of the three arrangements is used.

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4. *See* Steve Berkowitz, *Tax-Free Buyouts? Coaches Take a Chance with the IRS*, USA TODAY (Nov. 6, 2013), *available at* http://www.usatoday.com/story/sports/ncaaf/2013/11/06/college-football-coach-pay-buyouts-taxes-irs/3449639/, *archived at* http://perma.cc/EK33-9UJH (last visited March 10, 2015 at 1:26 PM) (stating that the coaches faced responsibility for their contract buyouts). However, I argue that such payments should not be included in the coach's income. *See* Douglas A. Kahn & Jeffrey H. Kahn, *Tax Consequences When a New Employer Bears the Cost of the Employee's Terminating a Prior Employment Relationship*, 8 FLA. TAX REV. 539 (2007). This debate is further explained *infra* Part IV.

5. *See* Berkowitz, *supra* note 2 (detailing Charlie Strong's signing with the University of Texas and buyout from the University of Louisville).

6. The University of Louisville followed the same structure when it replaced Strong and hired its new head football coach, Bobby Petrino, from the University of Western Kentucky. The school also paid the exact buyout amount in order to purchase Petrino's contract. *Id.*

7. *Id.*

8. *Id.* Since the "schools" are tax-exempt entities, it is not clear what taxes they are "avoiding." One explanation is that since the coach avoids taxes, the school avoids having to gross up the reimbursement of the buyout.

II. TAX CONSEQUENCES OF A BUYOUT: THE SERVICE'S POSITION

It is well established under regulations promulgated by the Internal Revenue Service (the "Service") that an employee must include in income the payment or reimbursement of an employee's personal obligation.[9] In the typical buyout scenario, the coach pays the buyout directly to the old university employer and is then reimbursed by the new university employer. There is no question that the contractually required buyout payment is a personal obligation of the coach.

Under this construct of the transaction, the coach may also deduct the cost of the buyout as a business expense under Internal Revenue Code § 162.[10] Since the coach is allowed a deduction, it appears that it makes no difference to the coach whether he has income or not on account of the payment of the buyout. If that deduction were not subject to any limitation (i.e., if it were fully deductible), it would offset the coach's income from the payment of the buyout and so it would make no difference to the coach whether the payment is excluded from his income or included in his income with an offsetting deduction.

The problem, as discussed in more detail in Part III, is that the Service would likely take the position that the deduction should be classified as a miscellaneous itemized deduction.[11] Miscellaneous itemized deductions are subject to several limitations. First, such deductions are deductible only to the extent that the aggregate amount exceeds two percent of the taxpayer's adjusted gross income.[12] Second, they are subject to the overall limitation on most itemized deductions under Internal Revenue Code § 68.[13] Finally, the largest issue is that miscellaneous itemized deductions are completely disallowed for purposes of the Alternative Minimum Tax.[14] With such

9. *See, e.g.*, Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 731 (1929) (holding that payment of income tax by an employer constitutes taxable income for the employee); *see also* Rev. Rul. 70-282, 1970-1 C.B. 16 (stating that an amount paid by an employer to cure an employee's indebtedness is taxable income for the employee); Rev. Rul. 66-41, 1966-1 C.B. 233 (stating that an employment agency fee reimbursed by the employer is taxable income for the employee).

10. 26 U.S.C. § 162 allows individuals to deduct the cost of "ordinary and necessary" business expenses. A payment made to end an employment contract is deductible under Code § 162. *See* Streger v. Comm'r, 113 T.C. 227, 231 (1999) (allowing a taxpayer to deduct the full cost of malpractice insurance for his business in the year that his business terminated).

11. *See infra* Part III (explaining the IRS's likely position regarding the University of Texas's purchasing of the employment contract rather than paying the buyout).

12. 26 U.S.C. § 67(a) (West 2012).

13. If a taxpayer's adjusted gross income for a taxable year exceeds an "applicable amount," then certain itemized deductions (including all miscellaneous itemized deductions) will be reduced. *See* I.R.C. § 68 (West 2012).

14. 26 U.S.C. § 56(b)(1)(A)(I) (2012).

large buyout payments required for many coaches, it is almost certain that these coaches will be subject to the Alternative Minimum Tax system. Therefore, under this interpretation of the tax results, there are likely two unfavorable outcomes: either the deduction for the buyout would not completely wash out the new employer's reimbursement or the buyout would not be deductible at all.

III. TAX CONSEQUENCES OF PURCHASING THE CONTRACT: THE SERVICE'S LIKELY POSITION

There is an argument that the University of Texas's new arrangement—purchasing the employment contract rather than paying the buyout—may allow the coach to exclude the buyout payment from his or her income. The coach could argue that the contractual buyout was never paid and the transaction was solely between the new and old universities. Since the buyout was not paid, the new university employer never paid a personal obligation of the coach. Thus, the argument goes, there is no income to the coach and the tax issue is avoided.

The Service, however, is unlikely to agree with this position.[15] Under the doctrine of substance over form,[16] the Service will

15. There is an interesting question as to the tax consequences for Strong in the unlikely circumstance that the Service were to accept the form of the transaction. Somewhat surprisingly, it has been reported that the University of Texas did not impose a buyout provision when it renegotiated Strong's contract (other than for some assistant coach salaries that would still be due). *See* Chris Hummer, *Charlie Strong: How Does the Contract of Texas' New Coach Compare with Texas A&M's Kevin Sumlin's Deal,* THE DALLAS MORNING NEWS (Jan. 14, 2014), *available at* http://collegesportsblog.dallasnews.com/2014/01/charlie-strong-how-does-the-contract-of-texas-new-coach-compare-with-texas-ams-kevin-sumlins-deal.html/, *archived at* http://perma.cc/U74L-3XWC. There is a question then of whether removing the buyout provision from the prior contract would trigger cancellation of debt income to Strong. *See* 26 U.S.C. §§ 61(a)(12), 108 (2012) (detailing discharge of indebtedness). There is an exclusion, however, of cancellation of debt income if payment of the debt would have been deductible. 26 U.S.C. § 108(e)(2) (2012). The question is whether that exclusion applies only if the payment would have been fully deductible—that is whether it applies to a deduction whose amount is subject to restrictions. As noted in this Essay, an unreimbursed buyout payment by Strong would be characterized as a miscellaneous itemized deduction and would, at best, be subject to limitations and, at worst, be fully disallowed under the Alternative Minimum Tax system. The author believes that the exclusion applies to all deductible items regardless of whether they are subject to limitations, but that is an open question. Also note that even if the University of Texas had imposed the same dollar amount of buyout requirement as was in the contract with the University of Louisville, Strong would have had cancellation of debt income because the cancelled debt was owed immediately whereas the new buyout debt would be both in the future and contingent.

16. When a transaction or series of steps to a transaction have no economic significance and are designed to obtain favorable tax consequences, the tax law will recharacterize the transaction (or the steps) so as to reflect the economic substance of what was accomplished. *See* Consol. Edison Co. of New York v. United States, 89 Fed. Cl. 228, 265–66 (2009) *rev'd and remanded sub nom.* Consol. Edison Co. of New York & Subsidiaries v. United States, 703 F.3d 1367, 1381 (Fed. Cir. 2013) ("The substance over form doctrine requires the courts to determine

presumably recharacterize the transaction to reflect the economic substance of the deal. In this case, the substance of the transaction is clear: the new university employer paid the buyout, thereby allowing the coach to be hired. It will bolster the Service's argument that the "purchase price" of the contract was exactly equal to the required contractual buyout requirement.

Therefore, it makes little difference for federal income tax purposes how the universities and the sought-after coach structure the transaction. Under all three arrangements discussed in this Essay,[17] the economic substance of the deal is the same: the new university employer is satisfying the personal obligation of the coach in order to allow the coach to terminate his old employment contract and sign a new one with the new university. The University of Texas's unusual arrangement has not solved the tax "problem" (if one exists). In other words, assuming the Service's position is correct, the result will be the same regardless of the arrangement—the coach will have income in the form of a personal obligation satisfied by the new university and the coach's corresponding business deduction for that payment will be classified as a miscellaneous itemized deduction. To the contrary, as discussed below, there are policy justifications for excluding the buyout payment from a coach's income.[18] Again the structure of the deal should not affect the tax consequences. Therefore, if either of the policy justifications is correct, a coach will not have income for the buyout payment regardless of how the deal is structured.

IV. REASONS TO EXCLUDE INCOME

A. Non-Itemized Deduction

As noted in Part II, if a coach was able to take a business expense deduction without any limitations for the payment (or deemed payment) of the buyout, there would be no tax concern. If the coach can classify the business expense deduction that he or she receives on account of the buyout payment as a non-itemized deduction[19] rather than a miscellaneous itemized deduction, then the coach may fully

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the 'true nature' of the transaction to ensure that tax consequences are based upon a transaction's actual substance and not mere labels." (internal citations omitted)).

17. *See supra* Part I (discussing three typical buyout scenarios that occur during the hiring of new college football coaches).

18. Much of this discussion stems from an earlier piece. *See* Kahn & Kahn, *supra* note 4.

19. Non-itemized deductions are fully deductible under both the "regular" income tax and the Alternative Minimum Tax systems. *See* 26 U.S.C. §§ 56, 58, 63, 67, 68 (2012) (detailing taxable income and deductions under the regular income tax and the Alternative Minimum Tax).

offset the income recognized by the new university employer satisfying the buyout. This key issue involves the classification rules of Internal Revenue Code § 62. Under that provision, most trade or business expenses classify as non-itemized deductions. There is an exception for business expenses incurred by a taxpayer whose trade or business "consist[s] of the performance of services by the taxpayer as an employee."[20] Clearly, football coaches are employees of the university. There is an exception to the exception, however. An employee business expense reverts back to a non-itemized deduction if the employer reimburses such an expense.[21]

Obviously, a coach is reimbursed for the expense of the buyout, but the reimbursement comes from the new employer. Thus, the new university employer reimburses the coach for an expense that the coach had prior to becoming an employee of the new university. That is, the employer reimburses the employee for an expense that was incurred while in the service of a different employer. The issue is whether that matters for purposes of § 62.

The Treasury Regulation corresponding to § 62 states that the services must be provided by the employee in his capacity as an employee of the employer who reimburses the costs.[22] This regulation should not be applied literally, however. To understand why, it is useful to examine why unreimbursed and reimbursed employee expenses are treated so differently for tax purposes. Congress is concerned that unreimbursed employee expenses might not be legitimate business expenses.[23] If the expenses were legitimate, it is Congress's position that then the employer likely would offer reimbursement.[24] Thus, rather than completely disallow unreimbursed expenses, Congress set severe restrictions on their deductibility.

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20. 26 U.S.C. § 62(a)(1) (2012).

21. There is a requirement (satisfied in these cases) that the employee substantiate the expense. *See* Treas. Reg. § 1.62-2(b).

22. *Id.*:

> For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses . . . paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party).

23. *See* Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1, 49–50 (2005) ("Congress has opined that employers will reimburse any legitimate trade or business expense, thus implying that anything not reimbursed is not sufficiently related to the business and must have personal elements.").

24. *See* S. REP. NO. 99-313, at 79 (1996) ("The committee believes that generally it is appropriate to disallow deduction for employee business expenses because employers reimburse employees for those expenses that are most necessary for employment.").

When an employer reimburses the expenses, the Service generally accepts this as third-party verification that the expenses were legitimate.[25] Congress is willing to eliminate the limitations and classify the expenses as non-itemized when a third party (like the employer) has signaled that the expenses are valid. However, it is not enough merely that the employer reimbursed the expense because it is possible that the reimbursement may be a method of compensation. Thus, the expense must be related to the business of the employer. That is, the employer must have a valid business reason, other than compensating the employee, for reimbursing the expense.[26] The expense must benefit the employer in some manner other than merely compensating the employee.[27]

In the buyout context, the benefit to the new university employer is clear. In order to hire the coach, the buyout must be paid. The new university then has a direct benefit from the expense and it makes no difference that the payment also benefits the employee.[28] Thus, even though the new university employer reimbursed an expense that the coach incurred while employed elsewhere, the payment meets the policy behind granting non-itemized status. It is both reimbursed by the employer (satisfying the third party verification requirement) and it provides a substantial business benefit to the employer (functioning beyond mere employee compensation). As such, the payment by the coach to terminate the old employment contract should be classified as a non-itemized deduction. As a non-itemized deduction, it will completely offset the income recognized when the new university employer pays the former university employer or reimburses the employee for the buyout.[29]

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25. *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 717–21 (2007) (detailing situations in which employer-reimbursed expenses are excludible and/or deductible).

26. Treas. Reg. § 1.162-2(a) suggests this with the language "in connection with the performance of services as an employee of the employer." Treas. Reg. § 1.162-2(a).

27. The Service uses a similar construction involving Code § 132. In determining whether an exclusion for a working condition fringe benefit is applicable, the Service, citing language similar to the Code § 62 regulations requiring that the expense be incurred in connection with the employer who provides the benefit, stated that the requirement is satisfied when the employer "derives a substantial business benefit from the provision of the property or services that is distinct from the benefit that it would derive from the mere payment of additional compensation . . . ." Rev. Rul. 92-69, 1992-2 C.B. 51.

28. It is also irrelevant that the Service requires the expense to be capitalized rather than immediately deducted. As universities are tax-exempt entities, it is not an issue whether it is deductible by the employer.

29. Kahn & Kahn, *supra* note 4, at 542–49.

B. Incidental Third Party Beneficiary

There is another policy justification for excluding the buyout payment from the coach's income. The reasoning of this justification is illustrated by a simple example. Assume that a law student hopes to land a job in New York City. If the law student spends his own money traveling to New York in order to interview with a law firm, those travel expenses are not deductible. In contrast, if the law firm reimburses the law student (or directly pays) for the travel expenses, the student would not be required to include the reimbursement or payment in income.[30]

These seemingly inconsistent results are nonetheless appropriate because the primary purpose behind the reimbursement or payment is to benefit the law firm. The law student obviously benefits as well (since he or she no longer has to pay for the travel expenses out of pocket), but the reimbursement is not meant to compensate the student. Instead, the firm spends the money in order to determine whether to hire the student and, if offered a job, to convince the student to accept it. While the student benefits, the law firm's purpose is to benefit itself.

The coach's situation is analogous. While the coach obviously benefits from the new university employer's paying for the buyout, the new university makes the payment not as compensation to the coach, but instead for valid business reasons to benefit the university.

V. CONCLUSION

The University of Texas's arrangement of directly buying the University of Louisville coach's employment contract does not relieve the coach's tax requirement to include the buyout in income. In this situation, the Service can argue that the substance of the transaction overpowers its form. The Service will likely recharacterize the transaction as a payment of the buyout funds to the coach who uses the funds to pay the buyout to his old university employer.

Despite this recharacterization, however, the payment by a university to buy out a new coach's contract should not require the coach to include the payment in income. The payment should qualify as a non-itemized deduction since it functions beyond mere compensation and satisfies the third-party verification requirement. Further, such payment may incidentally benefit the coach, but its fundamental purpose is to benefit the new university employer. If either argument is accepted, a coach would not pay taxes on the

30. Rev. Rul. 63-77, 1963-1 C.B. 177.

buyout. There may be other reasons to prefer to structure the buyout in this manner,[31] but it will not improve the case for exclusion of taxable income to the coach.

31. One possible explanation is that schools would prefer to not include the buyout payment amount as part of the compensation paid to the coach in the USA Today's annual survey of compensation paid to NCAA coaches. For the compensation list, see *2014 NCAAF Coach Salaries*, USA TODAY, *available at* http://sports.usatoday.com/ncaa/salaries/, *archived at* http://perma.cc/64H2-WLNC (last visited March 10, 2015 at 2:03 PM).