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Will the Tax Man Cometh To Coach Rodriguez?

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There has been much in the news recently about coaches of major college sports teams moving to a new school and incurring an obligation to make payment to their old school under a buyout provision in their contract.

The most recent example is the highly publicized move of Richard Rodriguez from West Virginia University to the University of Michigan. Coach Rodriguez had a contract with his former employer that required him to pay \$4 million dollars to West Virginia if he left for another coaching position. After a suit was filed, it was reported that the parties agreed that the \$4 million dollars will be paid to West Virginia, of which Rodriguez will pay \$1.5 million dollars in installments, and the University of Michigan (his new employer) will pay the remaining \$2.5 million.¹ How tax law applies to that buyout and whether Coach Rodriguez will incur federal income tax liability because of Michigan's payment of \$2.5 million are interesting questions. Simply put, will Michigan's payment of 62.5 percent of the buyout obligation cause the taxman to cometh to Coach Rodriguez?²

Some months ago, we published an article in the *Florida Tax Review* that focused on those issues.³ We concluded that a payment of a buyout fee to terminate an employment contract is a deductible expense, and that the employee does not incur income tax liability when the new employer pays all or part of his buyout obligation. The following commentary on those issues comes from that article.⁴

¹The University of Michigan also is reported to have agreed to pay the legal fees Rodriguez incurred.

²Assuming that Rodriguez's marginal tax bracket is greater than 30 percent, his tax liability would exceed \$750,000 if the \$2.5 million dollar payment by Michigan is included in his gross income.

³Douglas A. Kahn and 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). Coincidentally, the event that sparked the writing of that piece was a move by a *basketball* coach from West Virginia University to the University of Michigan.

⁴Portions of the commentary have been taken verbatim from the *Florida Tax Review* article.

I. The Deductibility of a Buyout Payment

Before considering the tax consequences of the payment made by the new employer, it is necessary to determine whether an unreimbursed payment by an employee to be released from an employment contract is a deductible expense under section 162. If the payment is fully deductible by the employee, it does not matter whether the new employer's payment of the buyout amount (or reimbursement of the employee for paying it) will be income to the employee. Even if the new employer's payment is income to the employee, the income is washed out by allowing a full deduction for the actual or constructive payment deemed made to the old employer.

"It has long been established that the cost of dissolution and termination of a business constitutes 'an everyday happening in the business world,'" and so "constitutes an ordinary and necessary . . . expense" that is deductible as a business expense if "directly connected with, or . . . proximately resulted from the taxpayer's business."⁵ A coach's employment is the coach's business, and so the cost of terminating that employment is a deductible business expense. However, an unreimbursed employee business expense is characterized as a miscellaneous itemized deduction.⁶

The problem with that characterization is that a miscellaneous itemized deduction is not fully deductible. The amount of those deductions is limited by sections 67 and 68.⁷ Moreover, miscellaneous itemized deductions are not deductible at all for purposes of the alternative minimum tax.⁸ Because of the large amounts Rodriguez will be paying to West Virginia, it is probable that the AMT will apply; if so, he will get little or no deduction for the \$1.5 million he will pay to West Virginia.

The proper treatment of the \$2.5 million that the University of Michigan will pay is another matter, and additional considerations apply.

II. The Employee's Tax Liability

There are important differences in the tax treatment of itemized and nonitemized deductions. Itemized deductions are subject to limitations that do not apply to nonitemized deductions. As noted above, miscellaneous

itemized deductions are subjected to especially rigorous limitations. On the other hand, a nonitemized deduction is fully deductible and is not subject to any of those limitations.⁹

Under the *Old Colony* doctrine, one person's payment of the tax liability of a second person is treated as if the second person had paid the tax and then was reimbursed by the first person.¹⁰ So, regardless of whether the University of Michigan were to pay West Virginia the \$2.5 million or reimburse Rodriguez for paying it, the transaction will be treated for tax purposes as if Rodriguez himself had paid it, and then was reimbursed by Michigan. In the usual case in which an employer pays an employee's liability, the employee will recognize gross income in that amount; and that was what occurred in *Old Colony*. Nevertheless, there are two independent reasons why the payment of part of the coach's buyout obligation by the University of Michigan will not cause him to incur tax liability.

A. Nonitemized Deduction

As previously noted, if Rodriguez's actual or constructive payment of the \$2.5 million that will be paid by Michigan is treated as a nonitemized deduction, it will be fully deductible and will therefore wash out the inclusion of the reimbursement of that amount in the coach's income. Most of the nonitemized deductions are listed in section 62(a). Section 62(a)(2)(A) treats an employee business expense as a nonitemized deduction if it is incurred in connection with the employee's services under a reimbursement or other expense allowance arrangement. The question is whether the actual or constructive reimbursement by the University of Michigan falls within that provision. The problem is that the services were for the prior employer (West Virginia) rather than to the new employer (Michigan). Can the payment qualify for nonitemization treatment in that circumstance?

Why should a reimbursed employee business expense be treated so much more favorably than an unreimbursed employee business expense? There are good reasons to criticize the code's different treatment,¹¹ but that is what Congress has chosen. The apparent rationale for making this distinction is that an employer's reimbursement provides third-party verification that the expenditure

⁵*Steger v. Commissioner*, 113 T.C. 227, 231, Doc 1999-31994, 1999 TNT 191-58. The fee will not be treated as a nondeductible capital expenditure of the employee even though it is incurred to permit the employee to qualify to take a new position. Reg. section 1.263(a)-4(e)(1)(ii) expressly provides that the "amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement . . ." See Rev. Rul. 2000-7, 2000-1 C.B. 712, Doc 2000-3874, 2000 TNT 27-22 (the cost of removing existing telephone poles to replace them with new poles is a deductible expense). The authors are indebted to Prof. Gregg Polsky for alerting us to this point.

⁶Sections 62(a)(1) and 67(b); reg. section 1.62-1T(e)(3).

⁷While the overall limitation of section 68 is being phased out, it is scheduled to return in full force for years beginning after 2010. Section 68(f) and (g), and the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, section 901(a).

⁸Section 56(b)(1)(A)(I).

⁹For a discussion of the classification of deductions as itemized or nonitemized and a criticism of that system, see Jeffrey Kahn, "Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification," 80 *Wash. L. Rev.* 1 (2005).

¹⁰The landmark Supreme Court case that promulgated that doctrine is *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). The treatment of a direct payment by an employer as a reimbursement of a payment constructively made by the employee is reflected in reg. sections 1.62-2(d)(1) and 1.162-17(b)(1).

¹¹One of the authors has criticized the code's harsher treatment of unreimbursed employee business expenses in two articles. See Kahn, "Beyond the Little Dutch Boy," *supra* note 9, at 20-25, 62-63; Jeffrey Kahn, "The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity," 57 *Hastings L.J.* 645, 677-679 (2006).

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had a legitimate business purpose.¹² Of course, not every reimbursement will verify this. An employer could reimburse a nonbusiness expenditure of an employee as a means of providing additional compensation for the employee's services. So, the statute requires that for nonitemization to apply, the expense be incurred in connection with services performed as an employee under a reimbursement plan with his employer and that the expense be deductible by the employee under one of the provisions in sections 161 to 169. Reg. section 1.62-2(d) indicates that the employee must have provided the services in his capacity as an employee of the person who is reimbursing the cost. How strictly should that requirement be construed?

The third-party verification purpose of the requirement is satisfied if the employer has a legitimate business purpose for paying the cost other than a purpose to compensate the employee for his services. The reason for the qualification requirement is to distinguish compensatory reimbursements from those that relate to costs that served a business purpose of the employer. A reasonable construction then is that the expenditure must provide a significant business benefit to the employer other than the benefit of compensating the employee, and that business benefit must be the primary purpose of the employer's making the payment. That construction was adopted by the Service in a similar context involving the application of section 132(a)(3), (d), the working condition fringe benefit exclusion.

In Rev. Rul. 92-69, 1992-2 C.B. 51, the Service held that expenses incurred and paid by an employer to assist terminated employees to locate work were excluded from the employee's income by section 132(a)(3) as a working condition fringe benefit. The ruling quoted from the applicable regulation (reg. section 1.132-5(a)(2)(i)) that for the statutory exclusion to apply, the expense must be "allowable as a deduction with respect to the employee's specific trade or business of being an employee of the employer." The ruling then construed that language as follows:

This requirement is generally satisfied if, under all the facts and circumstances, 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, and the employee's hypothetical payment for the property or services would otherwise be allowable as a deduction by the employee under section 162 of the Code.¹³

Similarly, the proper construction of the regulatory requirement for nonitemization characterization that the expense be incurred in the employee's conduct of the employer's business is that the expense must have a business benefit to the employer other than the benefit of compensating the employee. A reasonable addition to

this construction is that the business purpose of the employer must be the principal purpose of making the payment.

In the *Rodriguez* case, what was the business benefit to the University of Michigan? Michigan wished to employ Rodriguez and could not do so unless he was freed of his contractual relationship with West Virginia. To obtain Rodriguez's services, the buyout payment had to be made. It was a common interest of both Rodriguez and Michigan that he be released from his obligations to West Virginia. Michigan's payment was a cost of obtaining Rodriguez. It was not a deductible expense of Michigan's because it was a capital expenditure. Since Michigan is a tax-exempt entity, it does not matter to Michigan whether it could deduct the payment. For purposes of verifying the legitimacy of the expenditure, it does not matter that it was a capital expenditure as to the university. What matters is that the expenditure was made for a legitimate noncompensatory business purpose of the university and that the expense was deductible by Rodriguez under section 162.

The fact that Rodriguez also benefited from the university's payment does not alter the nonitemization characterization of the deduction. There is no prohibition against a business expense of an employer's benefiting the employee as well provided that the principal motive for making the payment was not to compensate the employee. For example, if an employee were to travel to Paris on a business trip for his employer, the reimbursement of the travel expenses would provide nonitemization treatment for the expense even though the employee greatly enjoyed his free time in Paris.

When an employee's reimbursed business expense is a nonitemized deduction, it effectively eliminates the income recognized by the employee from the receipt of the reimbursement. Rather than require the employee to report the income and offsetting deduction, which nets out to zero, the regulations permit the employee in some cases simply to exclude the reimbursement from income and not claim a deduction for the payment, provided certain conditions are met that ensure the expense will be open to inspection by the Service if questions arise.¹⁴ That regulation treats a direct payment of an employee's expense as a constructive payment by the employee followed by a reimbursement from the employer.

B. The Employee Is an Incidental Beneficiary

If a taxpayer incurs an expense on behalf of another person, whether or not employed by that other person, a reimbursement to the taxpayer will not be included in the taxpayer's gross income even if the taxpayer also benefited from the expenditure. For example, while the expenses of seeking employment in a business in which the taxpayer was not previously engaged are not deductible, if the taxpayer is reimbursed for his expenses by the prospective employer who invited the taxpayer to travel to be interviewed, the reimbursement is not income to the

¹²See Leandra Lederman, "Statutory Speed Bumps: The Role Third Parties Play in Tax Compliance," 60 *Stanford L. Rev.* 695 (2007).

¹³Rev. Rul. 92-69, 1992-2 C.B. 51, 53.

¹⁴Reg. section 1.162-17(b).

taxpayer regardless of whether he is hired.¹⁵ The taxpayer clearly benefits from having the opportunity to visit the firm. He has the opportunity to convince the firm to employ him, and he has the opportunity to see whether he would like to work there. But the firm's purpose in reimbursing the taxpayer is not to compensate him. Rather, it wants the opportunity to interview the taxpayer, and to convince him to accept an offer if after the interview it is determined that there is a good fit. The Service has agreed that the taxpayer does not have income from the receipt of the reimbursement regardless of whether the taxpayer secures a position with the firm.

Several revenue rulings shed light. In Rev. Rul. 66-41, 1966-1 C.B. 233, the taxpayer incurred a liability to pay an employment agency a fee for locating a job that the taxpayer accepted. The fee was a personal obligation of the taxpayer. The new employer agreed that if the taxpayer performed satisfactorily for a stated period of time, the employer would reimburse the taxpayer for the agency's fee. The Service ruled that the employer's reimbursement was income to the taxpayer. The ruling was subsequently distinguished in a ruling on similar facts, but with an important difference.

In Rev. Rul. 73-351, 1973-2 C.B. 323, an employer contracted with an employment agency to pay a fee for any person it hired through the agency. The new employee did not have to pay the agency. The Service ruled that employer's payment of the fee was not income to an employee who had been hired through the agency. The Service noted that Rev. Rul. 66-41 was distinguishable and inapplicable.

The difference between the facts of those two rulings is instructive. In the 1973 ruling, the employer's payment of the fee was for the purpose of obtaining the services of the taxpayer, but it was not given for services performed by the taxpayer or to be performed in the future. This is similar to the circumstance of Rodriguez. The fee in the 1973 ruling would have been a personal obligation of the employee if the employer had not agreed to pay it, and yet the payment was not income to the employee. The payment was a business benefit to the employer, but also benefited the employee.

In contrast, the fee paid in the 1966 ruling was paid only after the employee performed services for the employer and the services were judged to be satisfactory. Those facts indicate that the principal purpose of the payment of the fee was to compensate the employee for the satisfactory performance of services for the employer. As additional compensation, it was proper to include the payment in the employee's income.

There is another example of a circumstance where a taxpayer does not have income from another's payment even though the taxpayer benefits from it. This example is drawn from corporate tax law. A B reorganization is an acquisition of stock of a target corporation from its shareholders in exchange for voting stock of the acquiring corporation. One of the requirements for obtaining nonrecognition treatment for the exchange is that the shareholders of the target receive no compensation for

their stock other than voting stock of the acquiring corporation.¹⁶ The reorganization expenses incurred by the shareholders of the target are their personal liability. Those reorganization expenses can include legal and accounting fees incurred by the shareholders provided they are directly related to the reorganization. Incurring those expenses benefits both the shareholders and the acquiring corporation. Since those expenses are of mutual benefit to both the shareholders and the acquiring corporation, the Service has ruled that the acquiring corporation's payment of those expenses does not constitute consideration paid to the target's shareholders and so does not prevent the exchange from qualifying for nonrecognition treatment. Similarly, Michigan's payment of part of the buyout obligation should not be income to Rodriguez since it was of a mutual benefit to both Michigan and Rodriguez.

III. Conclusion

Michigan's payment of a portion of the buyout that Rodriguez owed to West Virginia should not cause Rodriguez to incur income tax liability for two separate reasons. First, because the constructive reimbursement to Rodriguez should elevate the constructive payment Rodriguez made to West Virginia to the status of a nonitemized deduction, which would wash out any income he recognized from the receipt of the constructive reimbursement. This second is that the payment constitutes a noncompensatory payment for the business purpose of Michigan (of which Rodriguez was merely an incidental beneficiary).

While we have concluded that Rodriguez should not incur tax liability, there is no certainty as to how this issue will play out if litigated. We are convinced that the proper result is to exonerate Rodriguez from tax liability, but litigation does not always achieve the optimum result.

The issues discussed here are much broader than the specific problem faced by Rodriguez or the problem faced by any new employee whose new employer reimburses or directly pays termination fees for the departure from a prior job. These issues arise in numerous contexts. It will be interesting to see how the issues are resolved.

One concern that the position urged by the authors in this paper might raise is that it leaves open the possibility that a new employer and employee might arrange for the new employer to pay the new employee's termination fees in exchange for the new employee's accepting a reduced salary. It would be difficult to police that type of collusion. But, unless and until it takes place, this problem can be left to the substance-over-form rules or legislative restrictions. The requirement that the employer's business purpose be the primary reason for making the payment is a restriction that addresses this problem. A legislative cure can address a specific abusive

¹⁵Rev. Rul. 63-77, 1963-1 C.B. 177.

¹⁶Section 368(a)(1)(B). In the case of a so-called triangular B reorganization, voting stock of a parent corporation of the acquiring corporation can be used.

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situation that arises without preventing the proper treatment of payments that are not part of a disguised compensation arrangement.

Moreover, the potential for parties to collude to disguise the true nature of a transaction is not unique to reimbursements for buyout payments. It exists in many circumstances including the current treatment of fringe benefits for employees and the treatment of an em-

ployer's reimbursement of travel expenses for a temporary employee. The Service and the courts have been able to deal with those situations when they arise. The tax law generally has chosen to deal with specific abuses separately rather than to inoculate against them by prohibiting the appropriate tax treatment of legitimate transactions.