Forbes

Robert W. Wood
THE TAX LAWYER

TAXES 12/30/2014

No Mickey Mouse Taxes On Jim Harbaugh's $48M Michigan Deal And 49ers Exit

Who is paying for Jim Harbaugh's lush $48 million contract? Nominally, it may be the University of Michigan, but Forbes' Mike Ozanian quips that it's really Mickey Mouse who will pay. It isn't chump change. ESPN reported that Harbaugh's record six-year contract with the Wolverines is worth at least $48 million. Disney can afford it, and a rich TV contract will get richer. And with Michigan's 4.35% state tax vs. California's 13.3%, Harbaugh will save on taxes too.

Given the sometimes obvious tensions between Harbaugh and the 49ers, the 49ers organization and Harbaugh have handled the events with usual grace. As Mike Ozanian noted, it has all been very clean, but it could have been very messy. And it isn't just about appearances but money. If Harbaugh had forced the 49ers to fire him, he could have perhaps collected as much as the final $5 million owed him for the final segment of his five-year contract.

But there was evidently also a buyout clause in his contract that called for him to pay the franchise $3 million to $5 million if he left for a college job before the conclusion of his 5 year deal with the 49ers. With only one year left on Harbaugh's 49ers contract, Ozanian suggests that it is safe to assume that Harbaugh was really only entitled to something in the range of $3 million for his last year. Even so, it could have played out differently.

If it had, Michigan would presumably have paid the $3 million buyout to the 49ers, not Harbaugh himself. But this mutual agreement between the 49ers and Harbaugh means Michigan can pay that $3 million directly to Harbaugh. By the same token, rather than lay out extra millions to a departing coach, the 49ers can apply the money they could have owed Harbaugh in 2015 to the new head coach they now must hire. It seems like a win-win.

But since these contract buyouts with coaches are common, how are they viewed by the IRS? It isn't a win-win for Uncle Sam. After all, just about everything is taxable, right? If money changes hands, someone must pay. If a contract is cancelled and money is paid, it is usually taxable right. Consider who pays and who receives the money, and even the taxable or tax-free nature of the contracting parties.

The point was recently raised by Pepperdine Law Professor Paul Caron, who notes in Tax-Free Buyouts of Coaches' Contracts that there are disagreements over who should pay what. Now, even USA Today is raising the point, noting that some schools are buying coaches' contracts instead of buying them out. Say a university wants to hire a new coach. But the coach—take Harbaugh—has a contract (say with the 49ers) that makes him stay. The university (say Michigan) pays the 49ers to get him out of the contract.

It is perfectly legal. But the question is who pays the taxes? To at least a few schools, the answer is nobody. The universities of Texas, Louisville and Alabama at Birmingham have reportedly found a way to structure their deals to avoid taxes. It works like this. You pay the coach's current school for the rights to his contract, and then you renegotiate it. The universities say that this approach saves cash and saves taxes.

The coach does not owe a buyout for terminating his contract, since he technically does not terminate the contract. The contract transfers to the coach's new university, which reaches a new arrangement with the coach. USA Today notes that Louisville received $4.375 million when coach Charlie Strong left for Texas. But this money did not come from Strong. Instead, with Strong's blessing, Louisville sold his contract to Texas. Texas assumed all of that deal's rights and obligations, and agreed to pay Louisville $4.375 million, the same amount as Strong's buyout.

It's an approach intended to avoid income taxes for coaches, and to save the universities money too. But naysayers point out that the tax law is not so easily fooled. Under federal tax law, a payment made by an employer to satisfy an employee's personal obligation is, guess what? It is taxable income to the employee. To the schools, of course, a buyout payment is viewed as a business expense.

How the IRS or the U.S. Tax Court would view these deals may still be an open question, according to Jeffrey H. Kahn, a professor at Florida State's law school. Kahn and his father, Douglas A. Kahn, a professor at the University of Michigan law school, wrote a 2007 law review article about buyouts: Tax Consequences When a New Employer Bears the Cost of the Employee's Terminating a Prior Employment Relationship. It may sound like dry reading, but if you had millions riding on the deal and an employer eager to sign you up, wouldn't you play along?

In the meantime, should Harbaugh be happier paying state income tax in Michigan? You bet. At 4.35%, Michigan is a comparative bargain over California's top 13.3%. The difference on $48 million would buy a lot of khakis.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.