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TAX CONSEQUENCES WHEN A NEW EMPLOYER BEARS THE COST OF THE EMPLOYEE'S TERMINATING A PRIOR EMPLOYMENT RELATIONSHIP

by

Douglas A. Kahn

Jeffrey H. Kahn

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I. INTRODUCTION

The next few months will be busy ones for moving companies that have NCAA basketball coaches as customers. In the past few months, several men's college basketball coaches have accepted jobs at different schools.¹ Several of those coaches, who were still under contract at their former institution, had buy out provisions that allowed them to terminate their relationship for a set price.² John Beilein is a prominent example of this since his buy out price was so high.

Last season, Beilein was the head basketball coach at West Virginia University where he was under contract with the school until 2012. On April 3 of this year, the University of Michigan hired Beilein to become the head coach of its men's basketball team. Under his contract with West Virginia University, if Beilein left that position before the contract term expired, he was required to pay a specified amount to the university. Initially, it was reported that the amount to be paid was in the vicinity of \$2,000,000 to \$2,500,000.³ Subsequently, it was reported that West Virginia and Beilein agreed that

* Paul G. Kauper Professor, University of Michigan Law School.

** Professor, Pennsylvania State University, Dickinson School of Law. The authors wish to thank Professor Gregg Polsky for his helpful comments on the piece.

1. For example, Steve Alford is leaving the University of Iowa to coach New Mexico State, John Pelphrey is leaving South Alabama to coach Arkansas, Billy Gillispie is leaving Texas A&M to coach Kentucky, Bob Huggins is leaving Kansas State to coach West Virginia, Tubby Smith is leaving Kentucky to coach Minnesota, John Beilein is leaving West Virginia to coach at Michigan, and Todd Lickliter is leaving Butler to coach at the University of Iowa.

2. Both Huggins (under contract at Kansas State) and Beilein (under contract at West Virginia University) were required to pay the university in order to terminate the contract.

3. Under the employment contract with West Virginia University, Beilein was required to pay \$500,000 per year for the number of years remaining on the contract. Beilein had five years remaining and thus most news stories reported the payout amount as \$2,500,000, but considering the time-value of money, an up-front payment should be less.

Beilein would pay the university \$1,500,000 over a five-year period in full settlement of his obligation.⁴

Prior to Beilein's hiring, there was speculation in the media that the University of Michigan would pay West Virginia University the amount owed under Beilein's contract.⁵ The question then arose as to the tax consequences to Beilein that such a payment would engender.⁶

The determination of the tax consequences to an employee whose new employer makes the buy out payment owing to the employee's prior employer raises issues that can arise in numerous circumstances and so warrants consideration. While we focus on Beilein's facts in this article, that is merely for convenience; and the issue is of much wider significance. The tax treatment of buy out obligations is merely a subset of the broader question of how to tax a new employer's payments of personal obligations of the new employee that are connected to the commencement of the new employment. For example, a new employer's payment of the fee owed by the new employee to an employment agency for locating the job raises similar issues.

There were three possible methods for the University of Michigan to address Beilein's buy out provision: (1) the University of Michigan could pay, or reimburse Beilein for, the required buy out; (2) while the University of Michigan would neither pay the required buy out amount nor specifically reimburse Beilein, the university could pay Beilein a higher salary in order to offset or mitigate his buy out expense and (3) the University of Michigan could neither pay the buy-out nor reimburse Beilein, and no additional compensation would be paid to Beilein to offset his expense. According to reports, the deal between the University of Michigan and Beilein adopts the third option.⁷

4. See Nathan Fenno, "Beilein, West Virginia reach deal on buyout," *The Ann Arbor News*, Apr. 27, 2007, p. B5. The report does not indicate whether any interest is payable on the installment payments nor does it indicate why West Virginia agreed to settle for less than the contract amount. Note that the cancellation of a portion of Beilein's debt does not cause him to recognize any income. See Jeffrey Kahn & Joshua Fershee, *Tax Magic: Did Billy Donovan Pull Income Out of a Hat?*, 116 *Tax Notes* 389 (2007).

5. See, Michael Rosenberg, "Ball Appears in Beilein's Court," *Detroit Free Press*, Mar. 29, 2007 ("Early in the process, Beilein's \$2.5 million buyout looked like a potential deal-killer. Not anymore. The buyout has been the one constant in the whole process - Martin [Michigan's Athletic Director] knew from the beginning that he would have to write a big check to get Beilein.")

6. See "Beilein's Buyout Price Has Variables" *Ann Arbor News*, Mar. 31, 2007.

7. According to University of Michigan officials, the University of Michigan did not pay the buy out which was viewed by the University of Michigan as a personal obligation between Beilein and West Virginia University. See "Beilein to earn more than \$1 million a year" *Ann Arbor News*, Apr. 4, 2007 ("No language about Beilein's \$2.5 million buyout with West Virginia is included in the contract. The athletic

This article will examine the possible tax consequences for each of the three options.

II. THE TAX CONSEQUENCES OF EACH OF THE THREE APPROACHES THAT ARE AVAILABLE TO THE NEW EMPLOYER AND THE EMPLOYEE

A. The Tax Consequences When the New Employer Makes the Buy Out Payment or Reimburses the Employee

Originally, the media assumed that the University of Michigan would either pay the buy out directly or reimburse Beilein for the payment. As noted above, contrary to that assumption, the parties have asserted that the University of Michigan will not bear any of that cost. Nevertheless, it is useful to determine what would have been the likely tax consequence if the University of Michigan had paid or reimbursed that liability. Since buy out provisions are common in certain types of employment contracts,⁸ that issue is likely to arise in the future. Of the three available options, the question of the tax treatment of a new employer's payment or reimbursement of the buy out expense is the most interesting and potentially the most controversial.

In determining the tax consequences when the new employer bears the buy out liability, it makes no difference whether the employer makes the buy out payment directly or reimburses the employee for making it since the substance of those two circumstances are identical. The tax law will treat those two circumstances the same; that is, even if the new employer makes the buy out payment directly to the old employer, it will be treated as a payment by the employee followed by a reimbursement from the new employer.⁹

department official said Michigan won't be responsible for the sum.") and "Contract buyout was not an issue" Ann Arbor News, Apr. 5, 2007 ("Michigan won't be responsible for any of Beilein's \$2.5 million buyout with West Virginia.. 'It never came up, and there's no way Michigan would have ever paid it,' [athletic director Bill] Martin said.")

8. For example, both Beilein and Huggins have buy out provisions in the contracts with their new schools.

9. See Regs. §§ 1.62-2(d)(1), and 1.162-17(b)(1). While Regs. § 1.62-1T(e)(5) refers the reader to IRC § 132 and the regulations thereunder for the treatment of an expense which is paid directly by the employer, it does not say that § 132 is the exclusive provision that deals with that situation; and it leaves open the possibility that the nonitemization provision of IRC § 62(a)(2)(A) can also apply. Moreover, any inference in that temporary regulation that § 132 might be the exclusive provision that applies to direct payments by the employer is contradicted by the final regulation, Regs. § 1.62-2(d)(1), that was adopted in a subsequent year. The subsections of § 132 that apply to direct payments are § 132(a)(3), and (d), the working condition fringe provision. But § 132(d) is not restricted to an employer's direct provision of property or services to an employee; it also can apply to cash paid to an employee to be used to

Beilein's buy out obligation arose out of his employment relationship with West Virginia University. It is his personal obligation. There is considerable authority that an employer's payment of an employee's personal obligation constitutes gross income to the employee.¹⁰ It is very likely, therefore, that the Service would contend that the new employer's payment of the buy out obligation is additional compensation to the employee and taxable to him. Contrary to that view, the authors contend that there are several strong and independent reasons why the employee will not bear any tax liability for such payments, and would likely prevail on that issue if it were litigated.

1. Deductibility of the Employee's Payment of the Buy Out

Before examining the tax liability issues, a preliminary issue must be resolved – that is, whether an unreimbursed buy out payment made by the employee to terminate his employment relationship with the former employer is a deductible business expense of the employee under IRC section 162. As we shall see, the resolution of that question is crucial to the resolution of one of the issues concerning the proper tax treatment of the payment by the new employer.

Note that if the employee's payment were fully deductible by him, then it would not matter whether the employer's payment or reimbursement constitutes income to the employee since any income recognized by the employee would be washed out by the deduction allowed to him. If the employer's payment or reimbursement is included in the employee's income, it is reduced to zero by the full deduction that the employee would receive; and that nets out to zero net income. If a payment or reimbursement is not income to the employee, then the employee would not be allowed a deduction since he would not then be treated as having made the payment. In either case, the net result is that the employee would have no tax liability. Indeed, since many reimbursed business expenses of an employee are nonitemized deductions for the employee, the Service allows the employee to omit those reimbursements from income and take no deduction for the expense rather than to bother reporting the income and the offsetting deduction on the employee's tax

pay for property or expenses. Regs. § 1.132-5(a)(1)(v). It is therefore highly unlikely that Regs. § 1.62-1T(e)(5) seeks to make § 132(d) exclusive since that would mean that it would be the exclusive provision applicable to direct payments by an employer, but would not be the exclusive provision that applies to reimbursements. Since § 132(d) applies to both, what reason could there be for making it exclusive as to one and not as to the other?

10. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929). See Rev. Rul. 70-282, 1970-1 C.B. 16, and Rev. Rul. 66-41, 1966-1 C.B. 233.

return.¹¹ As we shall see, while an employee's unreimbursed payment is deductible under IRC section 162, it is not fully deductible; and so further analysis is required.

A payment made by an employee to terminate an employment contract constitutes a business expense that is deductible under section 162. "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 under IRC section 162 as a business expense when "'directly connected with, or, as otherwise stated . . . proximately resulted from the taxpayer's business.'"¹² In the Beilein circumstance, the employee's prior employment constituted a business and so the cost of terminating that employment was a business expense that is deductible under section 162. However, an unreimbursed employee business expense is a miscellaneous itemized deduction.¹³

Miscellaneous itemized deductions are deductible only to the extent that the aggregate of such deductions exceeds 2% of the taxpayer's adjusted gross income.¹⁴ Moreover, the amount of the deduction is subject to the overall limitation on most itemized deductions imposed by section 68.¹⁵ In the case of a large payment, such as the amount payable under Beilein's contract to West Virginia University, those limitations are not likely to matter because

11. Regs. § 1.162-17(b)(1). To qualify for this permission to exclude both the income and the deduction, the employee must be required to account to the employer for the expenses, and must do so. This provision applies to expenses that are paid directly by the employer as well as to those that are paid by an employee who is reimbursed by the employer.

12. *Steger v. Comm'r*, 113 T.C. 227, 231 (1999) (quoting *Pacific Coast Biscuit Co. v. Comm'r*, 32 B.T.A. 39, 43 (1935)).

Since, in addition to being a cost of terminating a business relationship, the fee could also be viewed as a cost of facilitating the creation of a new contract, the question arises as to whether it should be treated as a nondeductible capital expenditure for the creation of a new contract. Reg. § 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 . . ." Thus, the payment to terminate an existing employment agreement is deductible. See Rev. Rul. 2000-7 (the cost of removing existing telephone poles in order to replace them with new poles is a deductible expense). The authors wish to thank Professor Gregg Polsky for making this point.

13. IRC §§ 62(a)(1), 67(b); Regs. § 1.62-1T(e)(3).

14. IRC § 67(a).

15. IRC § 68. The overall limitation of § 68 is being phased out by the Economic Growth and Tax Relief Reconciliation Act of 2001, but is scheduled to revive with full force beginning with the year 2011. See IRC § 68(f), (g); but see Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a), 115 Stat. 38, 150 (2001).

miscellaneous itemized deductions are not deductible at all for purposes of the Alternative Minimum Tax,¹⁶ and the presence of a large miscellaneous itemized deduction makes it a virtual certainty that Beilein would be subject to taxation under that system.

Consequently, if the employee's deduction cannot be excluded from the miscellaneous itemized deduction category, the employee will derive little or no benefit from it. If the employer's payment of the termination fee constitutes gross income to the employee, the employee will incur a large tax liability since little or none of his deduction for that payment will be of any use to him.¹⁷

Contrary to that unfavorable tax situation, it is the view of the authors that the new employer's payment of the termination fee that the employee owed will not cause any tax liability to the employee. There are two independent reasons why that is so. While each of those reasons can be questioned, if either one of them is held to be valid, the employee will not have any tax liability.

2. The Employee's Payment or Constructive Payment Constitutes a Nonitemized Deduction

A nonitemized deduction is one that is taken into account in determining adjusted gross income (AGI) and so is fully deductible under both the regular and the alternative income tax systems. None of the limitations that are imposed on itemized deductions is applicable to it.

In the Beilein type situation, the employee is reimbursed by the new employer for his payment (or constructive payment) of the buy out. As noted above, the payment qualifies as an employee business expense that is deductible under section 162; and, unless reimbursed by the employer, the deduction will be a miscellaneous itemized deduction. However, if reimbursed by the employer under a reimbursement arrangement, the payment or constructive payment of the employee will constitute a nonitemized deduction under section 62(a)(2)(A) if certain conditions are satisfied.¹⁸ Let us consider those conditions.

For an employee business expense to qualify for nonitemization treatment, the statute requires that the expense be incurred in connection with

16. IRC § 56(b)(1)(A)(I).

17. To make matters worse, if the employer pays the tax that the employee incurred from the employer's payment of the termination fee, the payment of that tax will also be included in the employee's gross income. *Old Colony Trust. Co. v. Comm'r*, 279 U.S. 716, 729 (1929). Moreover, if the employer then pays the income tax due on its payment of the employee's tax liability, that payment also will be included in the employee's gross income, and so on. Regs. § 1.61-14(a); *Safe Harbor Water Power Corp. v. U.S.*, 303 F.2d 928 (Ct. Cl. 1962).

18. Regs. § 1.62-1(c)(2).

the performance of services 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 199.¹⁹ The problem with applying that provision to Beilein's situation is that the services for which the expense was incurred were services to a different employer than the one who makes the reimbursement. Can the provision apply in that circumstance?

Treasury Regulation section 1.62-2(b) indicates that the services must be provided by the employee in his capacity as an employee of the employer who is reimbursing the costs.²⁰ The question is how strictly that requirement should be construed. Before answering that question, one should consider what rationale could explain why Congress has chosen to provide nonitemized treatment only for reimbursed employee expenses while subjecting the deduction of unreimbursed employee expenses to such severe restrictions. Why is an employee expense that is reimbursed by an employer treated so much more favorably than an identical expense that is not reimbursed?

There seems to be only one possible reason for such dramatically different tax treatments of identical expenditures. The employer's reimbursement provides a third party verification that the expenditure had legitimate business purposes.²¹ Presumably, Congress is concerned that an employee might claim a business purpose for what was primarily a personal expenditure, and so it severely restricted the deductions for such expenses unless they were verified by an employer's having determined that they were sufficiently beneficial to its business to warrant its bearing the cost.²² One might question the appropriateness of requiring third party verification only

19. IRC § 62(a)(2)(A).

20. Regs. § 1.62-2(b). That same restriction is stated in regulations involving related statutory provisions. See generally Regs. §§ 1.132-5(a)(2)(i) (involving working condition fringe benefits), 31.3121(a)-1(h) (involving FICA taxes), and 31.3401(a)-1(b)(2) (involving withholding taxes).

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

22. The miscellaneous itemized deduction concept was added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 132, 100 Stat. 2085, 2113-16 (1986). In the General Explanation provided by the Staff of the Joint Committee (the so-called Blue Book) for that Act, the Staff said:

“Congress concluded that the prior-law treatment of employee business expenses . . . have characteristics of voluntary personal expenditures. . . . The use of a deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer.”

Staff of the Joint Comm. on Tax'n, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 78-79 (Comm. Print 1987).

when an *employee's* expenses are involved, and one of the authors has previously done so,²³ but that is the path that Congress has chosen.

A reimbursement alone by an employer does not verify the business purpose of the employee's expense. An employer could reimburse an employee as a means of providing additional compensation to the employee. So, the statement in the regulations that the expense must be made in the employee's role as an employee of the reimbursing party serves to separate compensatory payments from those reimbursements of expenses that were beneficial to the reimbursing party.

How then should the regulatory requirement that the expense be incurred in connection with the employee's conduct of the employer's business be construed? A reasonable construction is that the expenditure must provide a significant business benefit to the employer, other than the benefit of compensating the employee. That construction was adopted by the Service in a similar context involving the application of IRC section 132(a)(3) and (d), the working condition fringe benefit exclusion. In Revenue Ruling 92-69,²⁴ the Service held that expenses incurred and paid by an employer to assist terminated employees to locate work elsewhere were excluded from the employee's income by IRC section 132(a)(3) as a working condition fringe benefit. The Service quoted from the regulations under IRC section 132 that for the 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."²⁵ The Service 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.²⁶

Similarly, the proper construction of the language of the regulations under IRC section 62 that the expense should be incurred in the employee's conduct of the employer's business is that the expense should have a significant

23. See, Jeffrey Kahn, *Beyond The Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 Wash. L. Rev. 1, 20-25, 62-63 (2005); Jeffrey Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parellilism and Horizontal Equity*, 57 Hastings L. J. 645, 677-679 (2006).

24. 1992-2 C.B. 51

25. *Id.* (Citing Regs. § 1.132-5(a)(2)(i)).

26. *Id.* at 53.

business benefit to the employer other than a benefit of compensating the employee. The purpose of the requirement to distinguish compensatory payments from reimbursements of expenses incurred on behalf of the employer is satisfied by requiring that there be a substantial business benefit to the employer, other than a benefit derived from compensating the employee.

In the Beilein case, what was the business benefit to the new employer? The University of Michigan wished to employ Beilein. They could not do so because Beilein was contractually prevented from leaving his current employment. However, Beilein's employer was willing, indeed contractually obligated, to release Beilein if it received a termination fee. The University of Michigan could obtain Beilein's services if it paid his employer a fee for terminating the contract. It would not be a deductible expense for the University of Michigan, but rather would be a capital expenditure.²⁷ However, for purposes of verifying the business purpose of the expenditure, it does not matter whether the expenditure was a deductible expense or a capital expenditure. In either event, it would be of substantial benefit to the new employer. While Beilein also would benefit from the payment in that he would be freed to take new employment, his benefit should not affect the characterization of the payment as one made primarily for the benefit of the University of Michigan. An employee often benefits from payments of employee expenses that are made primarily for the employer's benefit, and that does not cause them to be income to the employee. For example, an employee can be reimbursed by his employer for business travel to Paris, France, and the expense is still a nonitemized deduction for the employee even though he may have enjoyed his time in Paris.

As previously noted, Temporary Regulations section 1.62-1T(e)(5) could be construed to mean that there is a difference in treatment for expenses directly paid by the employer from those paid by the employee who is then reimbursed by the employer. Since the substance of those two circumstances are identical, there is no rational reason why they should be treated differently. As stated in footnote 9, *supra*, a more reasonable construction of that temporary regulation is to refer the reader to IRC section 132 as an additional provision addressing this circumstance rather than as an exclusive provision. In any event, as noted in footnote 9, in the unlikely event that the temporary regulation were read to mean that IRC section 132 is the exclusive provision that applies, it would be contradicted by Regulations section 1.62-2(d)(1) which is a final regulation and was adopted two years after the temporary regulation was promulgated.²⁸

The question of exclusivity turns on whether IRC section 132 was intended by Congress to preempt the nonitemization provision or merely to

27. Of course, since the university is a tax exempt entity, it would be of no consequence to the university whether the expense is deductible or not.

28. See also, Regs. § 1.162-17(b)(1).

provide an additional means of relief for the employee. Section 132(a)(3), (d) is not identical to the nonitemization provision of IRC section 62(a)(2)(A). Section 132(d) applies only to expenses that would be deductible by the employee under IRC sections 162 or 167. In contrast, IRC section 62(a)(2)(A) applies to employee expenses that are deductible under IRC sections 161 to 199. Since the nonitemization provision still requires the taxpayer to report both the income from the reimbursement and the deduction for the payment or constructive payment (subject to an exception for exclusion in certain specified circumstances), it is not surprising that it has a broader scope than does the exclusionary provision of IRC section 132(d). Section 132(d) is merely a codification of that part of the nonitemization provision that applies in circumstances where exclusion from income is appropriate as contrasted to circumstances where both income and an offsetting full deduction are to be reported.

Treasury Regulations section 1.132-5(a)(2)(i) states that a working condition fringe exclusion from income will apply only if the hypothetical payment made by the employee would be allowable as a deduction as an expense of the employee's conduct of the business of being an employee of the employer who provided the property or service. An employee in the Beilein type situation could not qualify for a working condition fringe since the employee's deduction for the buy out payment is attributable to his prior employment. This creates another important distinction between the nonitemization provision and the working condition fringe exclusion. As noted above, the application of the nonitemization provision should not be restricted to expenditures that would be deductible as having been incurred in the conduct of the new employer's business. Instead, it should be sufficient that the principal motive of the employer in reimbursing the amount is to obtain a benefit for the employer and not to compensate the employee. It is appropriate that the nonitemization provision have a broader scope than does the working condition fringe benefit exclusion.

In sum, Beilein's deduction for the payment should be a nonitemized deduction since it was reimbursed by a current employer for a business purpose other than to compensate Beilein. As a nonitemized deduction, it would wash out any income he would have recognized from the reimbursement.

3. The Employer's Payment is Excluded From the Employee's Income Because the Employee is Merely an Incidental Beneficiary of That Payment

If a taxpayer incurs an expense on behalf of another person, the reimbursement to the taxpayer will not be included in the taxpayer's income even though the taxpayer may have also benefitted from the expenditure. For example, while the expenses of seeking employment in a business in which the taxpayer was not previously employed are not deductible, if a taxpayer is

reimbursed for his expenses by a prospective employer who invited the taxpayer to travel to be interviewed, the reimbursement is not income to him regardless of whether he is hired.²⁹ The taxpayer clearly benefits from having the opportunity to interview the firm. He has an opportunity to convince the firm to offer him employment, and he has the opportunity to see whether he would wish to work for that firm. But, the purpose of the firm in reimbursing the taxpayer is not to compensate him. Rather, it is to provide the firm the opportunity to see if it wishes to hire the taxpayer and to convince the taxpayer to accept the offer, if one is made. The Service has agreed that the taxpayer is not taxed in that circumstance regardless of whether the taxpayer is offered a position and accepts it.

The Service, however, is likely to question whether the incidental beneficiary exclusion applies to a taxpayer who is employed by the person who makes the reimbursement. The leading case in support of applying that exclusion, even when the taxpayer is employed by one of the reimbursers, is the Fifth Circuit's decision in *United States v. Gotcher*.³⁰

In *Gotcher*, the taxpayer was an employee of a Volkswagen dealership in Texas. The taxpayer was offered the opportunity to purchase an interest in his employer. To help taxpayer determine whether to invest in a Volkswagen dealership in this country, his employer and Volkswagen of Germany and Volkswagen of America paid the expenses of taxpayer and his wife to travel to Germany and view Volkswagen manufacturing plants there. Upon returning from his trip, taxpayer invested in the dealership. The court held that the reimbursement of the taxpayer's expenses was not income to him, but the reimbursement of his wife's expenses was taxable.

The purpose of the employer and the manufacturers in reimbursing the taxpayer was to have him see the manufacturing plants in order to convince him that the investment in the company would be a good choice. In holding that the reimbursements were excluded from the taxpayer's income, the court cited cases that held that such expenses are taxable only when made primarily for the employee's personal pleasure. "On the other hand, when it has been shown that the expenses were paid to effectuate a legitimate corporate end and not to benefit the officer personally, the officer has not been taxed though he enjoyed and benefited from the activity."³¹ It is noteworthy that, in *Gotcher*, the benefit to the employer was to convince the taxpayer to invest in the employer's business. The reimbursements would be capital expenditures of the employer. Similarly, in the case of a Beilein-type reimbursement, the new employer's purpose in making the reimbursement would be a capital expenditure to acquire the services of the taxpayer.

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

30. 401 F.2d 118 (5th Cir. 1968).

31. *Id.* at 123.

While, in *Gotcher*, the court noted that the taxpayer had no realistic choice to turn down the offer of the trip, that does not mean that the principle applies only when the taxpayer had no option to reject the offer. Regardless of whether the employee's acceptance was required, the primary motive for making the reimbursement was to accomplish the corporate purposes of the reimbursers rather than to compensate the employee; and that is the crux of excluding the item from income. Moreover, in *Gotcher*, the employee was not required to accept the trip as a condition of his employment; at most, the court indicated that it was an implied condition of the company's accepting him as an investor (and even that seems dubious).

In Field Service Advice Memorandum 200137039 (June 19, 2001), the Service concluded that, in 1984, when Congress added the term "fringe benefits" to IRC section 61(a)(1) and adopted IRC section 132, it intended that thereafter any fringe benefit would be taxable to the beneficiary unless excluded by a statutory provision. The Service further concluded that since *Gotcher* represents a common law exclusion from income that preceded the 1984 Act, it did not apply to benefits provided to employees after 1984. That conclusion is questionable to the extent that it suggests that any non-wage benefit that an employee receives from his employer is a "fringe benefit." To the contrary, if an expenditure is not given in connection with the taxpayer's performance of his duties as an employee, as was the case in *Gotcher*, the fact that the taxpayer is employed by the reimbursers should not cause the taxpayer to be treated differently from a non-employee in the same position. Consider the following example:

X is employed as a bookkeeper by the Bilt Rite corporation which owns and operates a retail clothing store. In response to the consequences of a natural disaster that occurred in F city, which is located in another state, Bilt Rite decides to collect food and distribute it to needy people in F who have suffered losses. Bilt Rite seeks volunteers to help it conduct this project. X volunteers to travel to F and to assist in the distribution of the food. This project is not part of X's employment, and there was no expectation that he would participate. None of the volunteers, including X, is compensated for their participation; but Bilt Rite will reimburse the volunteers for their out of pocket expenses in traveling to F and living there while the food is being distributed. If the Service's 2001 FSA were correct, the reimbursement of those expenses would be income to X who might have no deduction for his expenses. The reimbursement of the expenses incurred by the volunteers who were not employees of Bilt Rite is excluded from their income. Surely,

the reimbursement of X's expenses should not be income to him merely because he is employed by Bilt Rite in a capacity that has nothing to do with his work at F. There is no reason to treat X differently from the other volunteers.

While the reimbursement in the Beilein situation would be related to his employment, they would not be made for actions taken in connection with the employment, which is the focus of the working condition fringe provision. Rather, they would be to make Beilein available to be hired by the university. This type of payment is outside the scope of section 132, therefore, the tax treatment of those payments should not be deemed to have been preempted by that section.

In Revenue Ruling 66-41,³² the taxpayer incurred a liability to pay an employment agency a fee for locating a job that the employee accepted. The fee was a personal obligation of the taxpayer. The new employer agreed that if the taxpayer performed satisfactorily in his work for a stated period of time, the employer would reimburse the taxpayer for the fee. The Service ruled that the payment by the employer was income to the employee. This ruling was distinguished by the Service in its 1973 ruling on a similar event.

In Revenue Ruling 73-351,³³ an employer contracted with an employment agency to pay a fee for any person it hired through the agency, and the employee would have no liability for the fee. The Service ruled that the payment of the fee by the employer was not income to an employee who had been hired through the agency. Since the employee never had any personal liability for the fee, the Service ruled that Revenue Ruling 66-41 was not applicable and was distinguishable.

At first blush, the differences between the facts of the 1966 and the 1973 rulings might appear to be of little substance. In both cases, it might seem that the payment was made by the employer to acquire the services of the employee. There is, however, a significant difference between the two sets of facts. In Revenue Ruling 66-41, the employee was required to work and perform satisfactorily for a period of time before the employer would agree to make the reimbursement. That clearly was a payment made for a compensatory purpose. In contrast, the payment in the 1973 ruling was made to acquire the services of the employee rather than to compensate him. What would be the result then if the employer did not contract with the agency to pay the fee before selecting the employee? What result if, instead, the fee had been payable by the employee, but the employer agreed to pay it without any requirement that the employee perform services for any period of time? The payment of the fee benefits both the employer and the employee. It is of mutual benefit to both.

32. 1966-1 C.B. 233.

33. 1973-2 C.B. 323.

The payment should not be treated as consideration paid to the employee. The tax treatment should not rest on the formulaic difference as to which had the obligation to make the payment. In this regard, it is instructive to consider the tax law's treatment of mutually beneficial expenditures in circumstances that arise in connection with corporate reorganizations.

A so-called "B" reorganization is an acquisition of stock of a target corporation from its shareholders in exchange for voting stock of an acquiring corporation. One of the requirements for obtaining nonrecognition treatment for the exchange is that no consideration be paid to the shareholders of the target other than voting stock of the acquiring corporation.³⁴ The reorganization expenses incurred by the shareholders of the target are the personal liability of those shareholders. Those reorganization expenses can include legal and accounting fees incurred by the shareholders provided that they are directly related to the reorganization. Incurring those reorganization expenses benefits both the shareholders and the acquiring corporation. Since they are of mutual benefit, the Service has ruled that the acquiring corporation's payment of those expenses does not constitute consideration to the target's shareholders, and thereby does not prevent the exchange from qualifying for nonrecognition treatment.³⁵ Similarly, an employer's payment of an employee's fee should not be income to the employee unless the payment is made for a compensatory purpose.

In summary, the university's payment of the buy out for Beilein should not cause Beilein to incur any tax liability either: (1) because the reimbursement should elevate Beilein's payment or constructive payment into a nonitemized deduction, or (2) because it should be excluded from his income as a noncompensatory payment of which he is merely an incidental beneficiary.

B. The Tax Consequences When the New Employer Pays Greater Wages to the Employee to Help Him Make the Buy Out Payment

From a tax viewpoint, this option is much less attractive than having the university pay or reimburse the buy out. In this case, there is no question, but that the extra compensation will be income to the employee, and the deduction the employee has for making the payment will be a miscellaneous itemized deduction. If the university were instead to pay the buy out directly or reimburse the employee for it, there is a reasonable prospect for its not causing the employee to incur tax liability, albeit he might not prevail on the issue. If,

34. IRC § 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. *Id.*

35. Rev. Rul. 73-54, 1973-1 C.B. 187.

instead, payment is made in the form of additional wages, the additional income tax liability is a certainty.

C. The Employee Makes The Buy Out Payment And Receives Nothing From The New Employer To Offset That Payment

It appears that this is the option that the parties adopted in the actual Beilein case. There are no special tax consequences to this choice. The employee received no income from the employer so he incurs no income tax liability therefrom. the payment made by the employee will be a miscellaneous itemized deduction which will be subject to the restrictions noted earlier in this article.

III. CONCLUSION

The only option that has any significant tax issues is the one in which the employer either pays the buy out directly or reimburses the employee. There are two independent grounds for contending that the employee incurs no tax liability therefrom. One contention is based on the ground that the reimbursement by the employer (or the constructive reimbursement if the new employer were to pay the former employer directly), converts the deduction the employee obtains for actually or constructively making the buy out payment into a nonitemized deduction. As a nonitemized deduction, it would wash out the income recognized by the employee because of the new employer's payment.

A second contention rests on the position that the payment made by the new employer is not income to the employee because it was made for the employer's own commercial benefit and was not intended as compensation to the employee. The authors refer to this proposition as an incidental beneficiary exclusion.

Both of the above contentions are vulnerable to attack. The authors believe that a taxpayer who litigates this issue will prevail, but there are no guarantees that that will be so. The policy considerations favor the taxpayer on this issue, and that is the reason for the authors' optimism. Good policy does not always prevail however.