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Tax Magic: Did Billy Donovan Pull Income Out of a Hat?

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Introduction

Everyone has the right to change his mind. The question this article addresses is whether a well-publicized about-face created income for federal tax purposes.

Billy Donovan is the men's head basketball coach at the University of Florida, where his team won the last two national championships. Perhaps seeking a new challenge,[1] Donovan turned his eye to the National Basketball Association and interviewed for the head coaching position of the Orlando Magic. The process moved quickly, and on May 31 Donovan agreed to become the new coach of the professional basketball team.[2] The next day, Donovan signed a five-year, $27.5 million contract with the Magic.[3]

Almost immediately after signing the contract, Donovan had second thoughts about joining the Magic and leaving Florida. Within days, Donovan contacted both the Magic organization and Florida and expressed his desire to revoke the deal and remain the head coach at Florida.[4]

At first, the Magic attempted to convince Donovan to honor his contract.[5] After it became clear that Donovan would not change his mind (again), "the Magic informed him that he would need representation to break the contract."[6] Although the details of the original five-year contract are not public, the Magic stated, "We have the legal right to hold Billy [Donovan] to the contract he signed."[7] What might the Magic have meant? Obviously, they couldn't compel performance of a personal service contract.[8] Presumably, the Magic meant that Donovan had a contractual obligation that would cause him to incur pecuniary damages[9] and lead to a possible injunction restricting his ability to coach elsewhere if he breached it.[10]

After some negotiation, the two sides reached an agreement that allowed Donovan to walk away from the employment contract with the Magic and remain the head coach at Florida. It appears, and we will assume for purposes of this article, that Donovan did not make a monetary payment to the Magic. As part of the deal, it has been reported that Donovan agreed to sign a contract that would restrict him from coaching in the NBA for the next five years.[11] For purposes of this article, we assume that to be true, and we refer to that second agreement as a noncompete agreement.

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[1]Travis Reed, "Donovan's Magic Kingdom, Magic's Coach Says He's Leaving Gainesville Looking for a Challenge," *Richmond Times-Dispatch*, June 2, 2007, at C1.

[2]*See* Pete Thamel, "Florida's Donovan Is Leaving for the Magic," *The New York Times*, June 1, 2007, at D5.

[3]*See* David Whitley, "Paid & Confused, 'Dollar Billy' Cashes In, but UF Shorts Urban," *Orlando Sentinel*, June 10, 2001, at C1. Donovan stood to receive a raise of nearly $3.8 million per year from the Magic. *See* Andy Staples, "Donovan Finally Free to Return to Gators," *Tampa Tribune*, June 7, 2007, at 1 (stating that Donovan had been in the sixth year of a seven-year deal with Florida that paid him $1.7 million annually).

[4]Lindsay Jones, "On Second Thought; Donovan, Magic Trying to Reach Resolution," *Palm Beach Post*, June 5, 2007, at 1C; *see* (Footnote continued in next column.) *also* "Magic Won't Hold Donovan to Deal," *Chicago Sun Times*, June 7, 2007, at 85. ("'I realized in less than 24 hours after signing a contract with the Magic that I had made a mistake that had nothing to do with the Magic,' Donovan said in a statement Wednesday night. 'Instead, I realized that, in my heart, I belonged in college basketball. As soon as I realized that, I contacted the Magic immediately to let them know.'")

[5]Staples, *supra* note 3, at 1.

[6]Brian Schmitz, "Strike Two? Donovan, Magic Reach Separation Agreement," *Orlando Sentinel*, June 7, 2007, at D1.

[7]Staples, *supra* note 3, at 1.

[8]*See* Richard A. Lord, *Williston on Contracts*, section 67:102 (4th ed. 1997). ("Specific performance of personal service contracts will not be decreed in favor of a willing employee, since the employer will not be permitted to enforce the agreement specifically against the contracting employee.")

[9]*See* E. Allan Farnsworth, *Contracts*, section 8.15, at 563-564 (4th ed. 2004) (stating that damages for a total breach of contract "are calculated on the assumption that neither party will render any remaining performance").

[10]*See New England Patriots Football Club, Inc. v. Univ. of Colorado*, 592 F.2d 1196, 1200-1202 (1st Cir. 1979) (upholding a preliminary injunction enjoining the university from employing a football coach while the coach was under a professional coaching contract).

[11]Staples, *supra* note 3, at 1 (stating that the terms of the agreement to allow Donovan to return to Florida were not disclosed, but that ESPN.com reported "that the Magic wanted Donovan banned from coaching in the NBA for five years").

The actual details of both contracts (the original five-year employment contract and the noncompete agreement) were not made public; thus it is not known whether there was a buyout provision in the original five-year deal. It seems likely that there was one, and the tax issue is more interesting if we assume that a buyout provision was present. Regardless of whether there was a buyout provision, Donovan would be liable for pecuniary damages for breaching the contract, so the assumption of a buyout provision merely adds a layer of certainty (and possibly a specific monetary value) to the amount of Donovan's liability.

In examining the question whether Donovan realized taxable income, we will discuss the tax consequences of two possible circumstances.[12] In the first circumstance, we assume the Magic released Donovan without receiving any compensation from him. The second (and seemingly more accurate circumstance) assumes that the Magic, in exchange for releasing Donovan from the employment agreement, required as compensation his execution of the noncompete contract.

Releasing Donovan for No Compensation

For purposes of analyzing the issues, assume that the Donovan-Magic employment contract contained a buyout provision; to put a figure on it, let's assume the amount was $2 million. That is, if Donovan voluntarily left the team (for example, to coach elsewhere), he would have been required to pay the Magic $2 million to be released from his contract with them. On that assumption, his obligation under the buyout provision would kick in once Donovan reneged on the Magic contract and returned to Florida.[13] Therefore, Donovan would have had a $2 million liability to the Magic.

Now assume the Magic allowed Donovan to walk away from the contract without paying any compensation.[14] By agreeing not to enforce the buyout provision, the Magic canceled Donovan's $2 million liability to them.[15] Unless an exception applies, Donovan would recognize income on account of that cancellation of debt under section 108(a). The closest statutory exclusion of income is the purchase-money debt reduction in section 108(e)(5). However, that provision applies only to sales of property and thus is inapplicable to the Donovan-Magic contract because no sale of property was involved in their agreement.

With one exception, however, the statutory exceptions to section 108(a) are not exclusive.[16] Judicially created exceptions, which are part of the common law of taxation, can also apply. One such exception applies to this situation.

The ''transactional approach'' exception, described in detail below, applies here and results in no income to Donovan despite his release from the $2 million liability. The principle that we refer to as the transactional approach is often applied but is not always called by that name. The transactional approach is derived from the rationale for taxing an individual when his debt is canceled — that is, it is merely a proper application of the cancellation of debt doctrine when the role of that doctrine is understood. In one sense, it is not really an

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[12]We can only speculate about what the actual circumstances might be, but the tax issues of the two that are examined in this article are worth exploring regardless of what actually occurred. Similar instances occur in many employment settings. Recent NCAA basketball examples include Dana Altman, who left Creighton to coach Arkansas but changed his mind one day after the announcement, and Gregg Marshall, who left Winthrop for the College of Charleston and returned shortly after his introductory press conference. *See* Pete Thamel and Liz Robbins, ''Donovan's N.B.A. Stay Is Expected to Be Brief,'' *The New York Times*, June 5, 2007, at D2. (''Marshall, who is now the coach at Wichita State, added, 'This happens all the time in all kinds of businesses and professions, but usually there's not a press conference involved.''')

[13]In fact, Donovan's indications that he did not wish to coach the Magic could have been deemed an ''anticipatory repudiation'' of the contract, which in most courts will give an injured party ''an immediate claim to damages for total breach.'' Farnsworth, *supra* note 9, section 8.20, at 583.

[14]Although this hypothetical may sound crazy, there may be valid reasons for doing so. For instance, the Magic likely recognized that it would be difficult to seek and hire a replacement coach if Donovan were still under contract. It would be rather difficult to woo a new coach to the Magic while engaging in a public fight with Donovan. The Magic may also have felt

(Footnote continued in next column.)

that it is not worth any bad publicity given that Donovan is a very popular coach in central Florida and the team is in the process of trying to build a new arena. *See, e.g.*, John Denton, ''4 Outcomes Magic Saga May Effect,'' *Florida Today*, June 10, 2007, at 4D. (''Though the Magic denied it to the hilt, part of the thinking going into the Donovan hiring was what effect would it have on the franchise's efforts to get the $480 million arena project passed.'')

[15]At first blush, that may sound unrealistic, but a similar situation occurred recently in the case of new University of Michigan basketball coach John Beilein. Beilein was under contract with West Virginia University when he agreed to coach at Michigan. His contract at West Virginia had a buyout provision that allowed Beilein to walk away if he would pay $500,000 per year on his remaining contract. Dave Hickman, ''Settlement Adequately Closes Book on Beilein,'' *Charleston Gazette* (W.Va.), Apr. 27, 2007, at P1B. Beilein had five years remaining, so the total buyout was, ignoring present value calculations, slated to be $2.5 million. *Id.* Beilein and West Virginia agreed to a lower buyout amount of $1.5 million. (West Virginia likely accepted a lower amount in part for goodwill and in part to avoid unnecessary legal fees.) *See id.* (stating that the cost of a battle over the buyout ''would be substantial in not only money but also in time, effort and aggravation''). As discussed in this article, that cancellation of debt should not create income for Beilein. For a more detailed discussion of the tax consequences of the Beilein case and the issue of a new employer paying the employee's personal costs in obtaining the new employment, see Douglas A. Kahn and Jeffrey H. Kahn, ''Tax Consequences When a New Employer Bears the Cost of the Employee's Terminating a Prior Employment Relationship,'' 9 *Fla. Tax Rev.* __ (forthcoming 2007).

[16]Douglas A. Kahn and Jeffrey H. Kahn, *Federal Income Tax* at 71 (5th ed. 2005). The one exception is that section 108(e)(1) makes exclusive the statutory insolvency exception (the provision that prevents recognition of income to the extent that the debtor is insolvent).

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exception but rather a proper application of the cancellation of indebtedness rule. Consider the following example.

A loans B $10,000. Despite having $10,000 more in assets than he had before the loan was made, B does not have income based on receiving the loan because B also has a corresponding obligation to repay the $10,000. B's net worth has not improved (assuming a reasonable rate of interest was to be charged). If a year later, when B is solvent, A cancels the $10,000 loan without receiving any consideration, B will have $10,000 of income if no exception applies. The reason that B has income is that B was not taxed on the receipt of the $10,000 cash because it was assumed that B would pay it back. We now know that B will not repay the $10,000, and so B has $10,000 of income.[17] The cancellation of indebtedness rule is required because the annual accounting principle prevents the IRS from redetermining the debtor's income for the year in which the loan was made; thus the cancellation of the debt is treated as income to take into account the income that was not recognized in the prior year because of an assumption that proved to be false.

The cancellation of a debt should cause recognition of income only when the creation or carrying of the debt prevented the debtor from recognizing income or the debt provided a tax benefit to the debtor (such as allowing the debtor to take a deduction). If a debt was not related to any increase in wealth and did not provide any tax benefit via a deduction, there is no reason to tax the debtor on the discharge of that debt. It is that principle that we refer to as the transactional approach.

As another example, suppose A purchased a painting from B for the stated price of $50,000; A paid $10,000 cash and promised to pay the remaining $40,000 in 12 months. After 12 months, for a valid business reason,[18] B agrees to cancel half the loan. Despite A's apparent increase in net worth because of the reduced loan amount, A will not recognize income because the cancellation is merely a renegotiation of the purchase price of the painting between the buyer and seller.[19] In fact, as noted above, section 108(e)(5) would apply to exempt A from recognizing income because the painting is property. But, even before that statutory exclusion from income was adopted in 1980,[20] case law had excluded the cancellation of A's debt from income.[21] The current statute, and the prior case law, treat the cancellation as a mere purchase price adjustment. Section 108(e)(5) essentially is a codification of merely one aspect of the transactional principle.

This same reasoning should apply to the Donovan-Magic agreement. The only difference between the assumed circumstance and the example involving the painting is that property was not involved in the Donovan case. Instead, the contract concerned services. There is no reason to limit the application of the transactional approach to agreements between buyers and sellers of property.[22] The statute mentions property because the cases that had arisen at that time involved property, but Congress did not intend to make the exceptions it listed to be exclusive, except for the insolvency exception.[23] Indeed, the fact that Congress expressly made the insolvency exception exclusive and did not do so for the other statutory exceptions indicates that the others are not exclusive. Thus, the transactional approach should apply and Donovan should not recognize income because of the cancellation of the buyout liability.

Releasing Donovan for Compensation

As noted above, the Magic did require compensation from Donovan to walk away from the contract. Specifically, the Magic appear to have required Donovan to sign a noncompete agreement that disallows Donovan from coaching any NBA team for the next five years. The question is whether that fact changes the above analysis so that Donovan must recognize income.

The IRS could argue that the result is different in this case. Donovan exchanged something of value — the noncompete contract — in exchange for release from at least some part of the $2 million buyout liability (or, if there were no buyout agreement, for some part of Donovan's pecuniary obligation for breaching his agreement). Viewed this way, it is not a cancellation of a debt by the Magic; instead, it is Donovan's satisfaction of the debt

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[17]*Id.* at 71. ("Thus, when a debt is discharged, the realization of income should not be attributed to the increase in the debtor's net worth at the time but rather should be viewed as a removal of a bar to including a prior increase in the debtor's assets in his income.")

[18]For example, if B determined that the painting was not by the artist stated at the time of purchase, which may have made it less valuable.

[19]Note that this adjustment in price would also reduce the basis in the painting to the new $30,000 purchase price.

[20]Bankruptcy Tax Act of 1980, P.L. No. 96-589, 94 Stat. 3389 (1980).

[21]*See, e.g., Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934) (finding that "there is an absence of such a gain or profit as is required to come within the accepted definition of income" when debt is canceled for a valid business reason).

[22]*Cf. Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990). Consider one last example that illustrates that a transactional approach is necessary to comport with the proper function of the cancellation of indebtedness rule. F makes a written promise to give G $5,000 one year later. Under state law, the written promise created a legal obligation even though F received no consideration for it. When the promise becomes due, F reneges and will not make the payment. G has a legal right to enforce the promise, but chooses not to do so and forgives the debt. While F's net worth is increased, the debt he created did not prevent him from recognizing income and did not provide any tax benefit for him. The cancellation of debt is not income to F, and should not be.

[23]Section 108(a)(1)(B) and (3) excludes a cancellation of debt from a debtor's recognition of income to the extent that the debtor was insolvent at the time that the debt was forgiven. The insolvency exception was applied by case law before it was codified in 1980. Section 108(e)(1) makes the statutory codification exclusive.

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using the noncompete contract as consideration. Payments for noncompete agreements are clearly taxable.[24] Thus, Donovan would recognize as income the amount of the canceled buyout obligation that is attributable to Donovan's execution of the noncompete agreement.

While Donovan could argue that the granting of the noncompete agreement was not a quid pro quo for the cancellation of any liability he had under the employment contract, why would he have executed that agreement if not to compensate for some pecuniary liability he might owe the Magic? We believe that the buyout (or other pecuniary obligation) should be bifurcated — some amount was in exchange for the noncompete contract and thus should require Donovan to recognize income. A larger percentage of it was an uncompensated cancellation of debt. That is, Donovan gave up the right to coach in the NBA for five years so that he could immediately return to Florida. The Magic, however, agreed to the noncompete agreement as partial compensation for releasing Donovan from the contract.[25] The remainder of the likely buyout provision was a cancellation of debt that the Magic likely deemed worthwhile so the team could save as much face as possible[26] while continuing to pursue their next head coach.

As explained above, the amount that is treated as an uncompensated cancellation of debt should not be taxable to Donovan under the transactional principle. Therefore, the amount that Donovan should be taxed on is limited to the value of the noncompete agreement.[27] While that valuation could be difficult to make, financial consultants with experience negotiating noncompete agreements could provide an estimate of the value of Donovan's five-year noncompete contract.

Conclusion

It may appear unfair for Donovan to have income when all he did was (fairly quickly) change his mind, something we all do. Usually such flip-flops do not have income tax consequences. But Donovan's case has an additional element. Donovan signed an employment contract that created a liability for a pecuniary amount if he breached it. Donovan had some liability even if there were no buyout provision. But a buyout, which likely was in his employment contract, will make it easier to value that obligation. To back out of his employment contract without paying the Magic any damages, Donovan entered into a noncompete contract. Relief of liability was Donovan's compensation for agreeing to that contract, and that should result in requiring him to recognize the value of that relief as income. In our view, only the amount of the canceled liability that constituted a payment for the noncompete contract should be taxable to Donovan. The balance of any forgiven liability, for which no compensation was received, should be excluded from income under the transactional approach to the cancellation of debt principle. The amount of the liability that is payment for Donovan's noncompete contract should equal the fair market value of that noncompete contract. The difficult issue is what that valuation should be. Although the IRS may argue that the value of the noncompete contract is the same as the full amount of the buyout clause (if one exists), because there was an exchange between parties negotiating at arm's length, we believe Donovan has a strong argument that the valuation should be substantially lower. However, unless Donovan has one more trick up his sleeve, he will have some amount of income that he cannot make disappear.

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[24]*See, e.g., Sigman v. Commissioner*, 31 T.C.M. (CCH) 1275 (1972). ("Compensation for refraining from the performance of services is clearly ordinary income.")

[25]*See Thompson v. Commissioner*, 73 T.C.M. (CCH) 3169 (1997) (stating that each party provided expert testimony about the value of some noncompete agreements, but that the tax court is "not bound by the opinion of any expert witness when that opinion is contrary to [the court's] judgment").

[26]"Orlando About Done With Donovan," *Chicago Tribune*, June 6, 2007, at 24. ("Orlando and Donovan are laboring to define their futures fast — Donovan to save his consensus No. 1 recruiting class at Florida, the Magic to save face.")

[27]The IRS could argue that Donovan received the value of the cancellation of the debt — the full $2 million — in exchange for the noncompete agreement because there was a clear dollar value for which Donovan would have been liable, and the buyout provision makes valuation clear. If the IRS pressed this issue, Donovan would at least have evidence that the true value of the buyout clause was less than the stated amount because colleges and professional sports teams regularly reduce or eliminate those provisions. *See supra* note 15 (discussing West Virginia's reduction of John Beilein's buyout provision when he left to become the University of Michigan basketball coach).

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