How Tax Reform May Affect Compensation in Collegiate Athletic Departments

The "Tax Cuts and Jobs Act" added a new 21% excise tax payable by tax-exempt organizations on "excess compensation" paid to their five highest-paid employees. At both private and state non-profit universities and colleges, many of these top-paid employees are going to be coaches and other members of collegiate athletic departments. The USA Today 2017 NCAA coaches' salary survey found that 76 college football coaches and 40 college basketball coaches had “school pay” of over $1,000,000 -- amounts that typically do not include incentive bonuses or other pay. An article last year by Vice Sports stated that 15 collegiate athletic directors at tax exempt universities had compensation over $1,000,000. Buy-out packages for coaches could also generate a large tax bill for colleges and universities. For example, the largest current buyout package for a collegiate coach belongs to Clemson’s Dabo Swinney at $40,000,000. For these reasons, the boards of trustees or the regents of these schools and their collegiate athletic departments will need to fully understand the new rules and potential strategies to minimize their impact.

This paper provides a detailed explanation of the new excise tax and its potential impact on athletic department compensation at tax-exempt private and public universities and colleges. Following the discussion of the rules and their application, this paper addresses possible strategies for minimizing application of the excise taxes.

How much is the new excise tax?

- The IRS will impose a 21% employer-paid excise tax on any remuneration paid to "covered employees" in excess of $1,000,000.
- The IRS will also impose a 21% employer-paid excise tax on any “excess parachute payment,” which is any severance pay to a covered employee if the severance pay equals or exceeds three times the covered employee’s “base amount” (as defined below). Once the excise tax is triggered by the determination that the severance pay equals or exceeds three times the base amount, the employer will pay the excise tax on any amount over such base amount.

For purposes of this paper, “excess compensation” means any compensation subject to the excise tax, which could result from paying compensation above $1,000,000 or from paying excess parachute payments.

To which tax-exempt colleges and universities does the tax penalty apply?

- Private tax-exempt colleges and universities -- Definitely. All organizations that are exempt from income taxes under section 501(c)(3) of the Internal Revenue Code (the “Code”) are subject to the new excise tax. Almost all private colleges and universities are 501(c)(3) organizations and are subject to the new excise tax on excessive compensation.
- State non-profit colleges and universities -- Maybe. For state universities and colleges, the analysis is a bit more complicated because they can be designated by the IRS as one of three types of entities: a 501(c)(3) organization, a 115 quasi-
governmental entity, or a political subdivision (or integral part) of a state government. As currently drafted, the excise tax does **not** apply to a state college or university that has been designated by the IRS as a political subdivision of its state government.

A state political subdivision is generally an entity to which the state has provided a significant delegation of authority to use one or more of the state’s police powers, which include the taxing power, police power and eminent domain. States and their public subdivisions are exempt from federal income tax based on the Constitutional doctrine of intergovernmental immunity – which is basically that federal and state governments do not generally tax each other. Common examples of political subdivisions are municipal corporations such as counties, cities or townships. On the other hand, a Code section 115 quasi-governmental organization is an entity whose income is exempt from federal taxation because its income is “derived from the exercise of any essential governmental function and accruing to a State or any of its political subdivisions.” State colleges and universities can seek a ruling from the IRS about whether the organization is exempt from tax as a 501(c)(3) organization, as a 115 organization or as a political subdivision of a state. Because all three are exempt from federal income taxes, it has generally not been very significant whether a state educational institution was designated as one of these organizations rather than another. The myriad factors that could affect a state school’s reasons for applying for one designation versus another are beyond the scope of this paper. However, there are a couple of significant reasons that state schools seek a 501(c)(3) designation: (i) 501(c)(3) organizations enjoy higher deduction limits for donations, and (ii) it is generally easier for foundations to make donations directly to 501(c)(3) organizations.

Based on this current system, very similar state universities and colleges have received different designations by the IRS, usually based on the type of designation requested by the school. For example, the University of California system is made up entirely of schools that have obtained IRS designations as 501(c)(3) organizations. On the other hand, the entire University of Texas system has been designated by the IRS as a state political subdivision. The University of Arizona has been designated as a 115 quasi-governmental entity. Based on the current statutory excise tax, compensation paid by the University of Texas school system to its coaches and athletic directors would not be subject to the 21% excise tax, but the same compensation paid by the University of Arizona or UCLA would be subject to the excise tax.

Some tax practitioners, including legislative counsel for the Congressional Joint Committee on Taxes, have said that this was an oversight by Congress that should be fixed in upcoming fiscal budget bills. However, state universities and colleges should monitor this issue closely to see whether or not Congress intended this exception. If it did, then the state school may want to reevaluate its current organizational structure to see if it should apply to the IRS for designation as a political subdivision.

**Who are covered employees?**

- **Five highest-compensated employees.** The law defines “covered employees” to include current or former employees who are among the five highest-compensated at the applicable tax-exempt organization. In the university setting, common positions that would fall into this definition include head coaches of certain sports and the athletic director, in addition to the president and other senior administrators. In a study of eleven private university Forms 990, the number of positions within an athletic department that would have been subject to the excise tax (if the law were applicable as of the filing date of the Forms 990) range from one to four (two or three being most prevalent).
• **Once a “covered employee,” always a “covered employee”**. The law requires applicable tax-exempt schools to determine who their covered employees were in 2017, and it will impose the excise tax on any future payments made by that university in excess of $1,000,000 in a taxable year (regardless of the employee’s status — as employed, contracted or retired and whether they continue to be one of the five highest paid—in future years).

• **Remuneration.** The five highest-paid employees are not identified based on the compensation amounts reported on a school’s Form 990. Instead, the five highest-paid employees are determined based on pre-tax amounts included in the employee’s pay during the school’s taxable year (calendar or fiscal). For example, nonqualified deferred compensation is not included in the employee’s pay until it is vested and non-forfeitable, even if the amount is reported on the organization’s Form 990 for the year. In fact, the five highest-paid employees listed on the Form 990 may be different from the five highest-paid employees who are considered covered employees for purposes of the excise tax.

• **Sample calculation of the excise tax applicable to a covered employee.** Assume a head basketball coach was one of the top five highest-paid employees at a private university in 2017. Further assume that due to poor athletic, academic and/or individual performance in 2018, s/he is not one of the top five highest-paid employees for that year. Last, assume that the coach earned $2,000,000 under the terms of the contract in 2018. Because the coach is forever deemed to be a “covered employee” based on his or her status in 2017, the university would be subject to an excise tax equal to $210,000 ($1,000,000*.21) for 2018.

• **Recordkeeping is critical.** Tax-exempt colleges and universities must track all covered employees beginning with the school’s 2017 fiscal year.

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**Welcome to the world of excess parachute payments**

• **Application.** The excise tax also applies if any severance payments (i.e., parachute payments) equal or exceed three times the “base amount.” The base amount is basically the employee’s average W-2 compensation in the prior five-year period (or if tenure is shorter than five years, the shorter period). If the severance payments equal or exceed three times the base amount, then all severance payments in excess of the base amount are subject to the 21% tax penalty – not just the amount in excess of the three times compensation. As a reminder, this penalty is paid by the employer, not the employee.

• **Example.** Assume that a coach’s buyout package is $8,000,000. Over the prior two years the coach had W-2 compensation of $2,600,000 and $2,300,000. The coach’s base amount would be $2,450,000 (prior two years’ compensation divided by two). Three times the base amount is $7,350,000. This year the university decides to terminate the coach without cause and hire a new coach. Because the buyout amount is over three times the base amount, the excise tax must be paid on any amount paid in excess of the base amount. The excess amount is $5,550,000 ($8,000,000 - $2,450,000). The excise tax would be $1,165,500.

• **No change in control needed.** In the for-profit world, the excise tax on excess parachute payments only applies if there is a change in control. For tax-exempt universities and colleges, it applies if any payment is merely contingent on termination of
employment and that contingent compensation is three times the employee’s base amount.

- **Clawbacks, cutbacks or best-net provisions.** For many years, the for-profit world has had to decide what to do in the case of excess parachute payments. For-profit employment agreements usually contain provisions to lessen the excise taxes payable in the event of a change in control. However, in the for-profit world, the employee and the employer have reasons to work together. In the event of an excess parachute payment, the employer loses its tax deduction for the excess amount, but it is the employee who pays the 20% excise tax. Under the new excise tax on non-profit excess parachute payments, the employee’s tax treatment does not change regardless of whether the payments are excess parachute payments. Only the tax-exempt entity is responsible for the excise tax. Nevertheless, tax-exempt organizations should consider adding provisions in employment agreements that could lessen the blow of the excise tax in the event of excess parachute payments. In the example above, the coach’s pay exceeded three times base compensation by $650,000 and the university ended up paying an excise tax of $1,165,500 (based on all severance pay above one times the base amount). In future employment agreements, tax-exempt schools may need to consider whether mitigation of the added excise taxes makes good business sense, and whether they should include clawback or cutback provisions so that no excess parachute payments exist.

**A Note about related organizations**

If a covered employee is paid excess compensation and a portion of the compensation is paid by a “related organization,” then the related organization actually pays a pro rata share of the excise tax based on the proportion of the amount it paid in total compensation for the year to the covered employee. A related organization is any organization that controls, or is controlled by, the college or university and any support organizations. Therefore, if a foundation or athletic association of a university pays a portion of a coach’s compensation, and the coach ends up with excess compensation, then the related organization must pay a pro rata share of the excise tax.

**Next Steps to Consider**

- **It’s a balancing act.** NCAA recruiting is highly competitive, and compensation for the highest-level programs is subject to scrutiny by multiple stakeholders, including those shown in this chart:
Boards of trustees, administrators and athletic directors of affected colleges and universities will need to balance the potential cost of excise taxes — and potential public relations issues related to their payment — with the need to pay competitive compensation to acquire top talent. This may be especially difficult because the likelihood that the excise tax will be triggered does not actually affect the taxation or value of the consideration being received by the coach or administrator. Agents and advisors may be wary about new or alternative compensation structures developed to avoid the schools’ potential liability for the excise tax. Therefore, school administrators will need sound advice on the best ways to communicate the idea that an alternative compensation structure can be a win-win situation.

**Action Items.**

- **What should athletic directors and other administrators do now?** This new excise tax is currently applicable to compensation of coaches, athletic directors and other senior administrative positions at applicable tax-exempt organizations. Therefore, affected schools should:
  - Identify covered employees and likely covered employees for future years;
  - Track all “covered employees” going forward (“once covered, always covered”);
  - Identify any existing compensation arrangements that might trigger an individual becoming a covered employee, either by being paid above $1,000,000 or by being deemed excess parachute payments;
  - Calculate the current potential excise tax liability for the current compensation arrangements of the school’s covered employees. Knowing what the potential liability is will assist the school’s board of trustees/regents and administrators in
weighing the potential negative effect of the excise taxes against potential negative consequences on the school’s ability to recruit and retain the talent necessary to maintain the school’s standards and expectations for its athletic and other programs.

- **What steps can be taken to minimize the amount of the excise tax?**
  - Consider whether mandatory deferrals of amounts that would be excess compensation could be used as a tool to prevent employees from becoming a “covered employee” by “leveling out” payments over a period of years. If the school does not manage this, the school could have significantly more than five employees subject to the excise taxes;
  - Review retention and/or leadership transition incentives;
  - Analyze whether the school is maximizing the potential for compensation that is not considered “remuneration” subject to the excise tax, such as tax-qualified retirement benefits and health benefits;
  - Seek advice regarding the potential impacts of alternative pay structures:
    - Michigan significantly reduced head football coach Jim Harbaugh’s annual compensation by entering into a split-dollar life insurance arrangement with him. The school pays a $2,000,000 annual premium under the policy (which is treated as a loan that will be paid out of the death benefit when the insured passes away) for a $35,000,000 life insurance death benefit.¹
    - Many schools have also provided their coaches with authority to enter into personal contracts with third-party vendors or advertisers in such a way that the coaches receive profits directly from those ventures. Some schools also guarantee a certain level of compensation if those arrangements do not return a certain profit to the coach.
    - The recent proposed regulations under Code section 457(f) also permit employers to use a non-compete provision as a post-termination vesting period. Amounts are not included in an employee’s W-2 compensation until the amounts “vest.” For example, if a university were negotiating for a three-year contract paying $1,800,000 (salary and bonus) per year, the university may be able to instead negotiate to pay no more than $999,999 per year and the remaining $800,001 will be paid each year during the three-year non-compete period. In that case, neither the annual salary, nor the amount paid during the non-compete period would be subject to the excise tax.
  - Understand the potential taxes associated with buy-out provisions to determine whether payments would equal or exceed three times the base amount, triggering an excise tax:
    - If a “covered employee's” compensation has increased significantly over the past five years, this might trigger the excise tax even though the current severance multiples are within competitive norms.
    - One area to consider is how the excise tax might apply when a university owes a fired coach liquidated damages that would clearly be an excess parachute payment. Are the liquidated damages paid upon termination of service considered a parachute payment? Because it was paid contingent

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¹ See pay methodology for 2017 USA Today NCAA coaches salary survey.
upon termination of service, it will should be considered an excess parachute payment.

- Alternatively, what if a coach terminates service prior to the expiration of the contract, owes a buyout to the university, but the recruiting university steps in and pays the buyout as part of its hiring of the coach (note that this is a prevalent practice)? Notably, the payout by the recruiting university is not a payment contingent on a termination of employment with the new university, so it seems that it would not be treated as a parachute payment. However, the payoff of the buyout would still be treated as compensation that the new university is paying to a covered employee that may exceed $1,000,000. However, recruiting university could negotiate with the new coach for deferred installment payments or other structures to level the payments to under the $1,000,000 excise tax threshold.

For some colleges and universities, this new excise tax could amount to millions of dollars each year being paid to the federal government instead of being spent on the schools’ academic and research missions. For those who determine that these excise taxes will be a material detriment to the school, as discussed above there are various strategies for minimizing this expense. On the other hand, because of the broad applicability of the excise tax and the amount of money some universities make from collegiate athletics, the new excise tax may simply be treated as an additional cost of doing business.

About the authors:

Marc Fosse is a director and shareholder at Trucker Huss APC, which is one of the nation’s largest compensation and benefits specialty law firms. For nearly two decades Marc has been providing practical solutions for clients on matters relating to all aspects of compensation and benefits. He advises many tax-exempt organizations, especially educational institutions and health care companies, in designing executive compensation programs and drafting and negotiating executive employment, retention, change in control and severance agreements. He regularly advises clients regarding the handling of compensation and benefit matters in corporate mergers, acquisitions, divestitures, initial public offerings and other corporate transactions. Marc is frequently asked to speak on compensation and benefits issues and has been quoted as a compensation expert in newspaper articles and compensation publications.

Josephine Gartrell is a Senior Consultant in Willis Towers Watson’s executive compensation practice working with university Boards of Trustees/Directors/Regents, committees of the Board, athletic directors, and other senior leadership to design compensation strategies that align with achievement of their academic and athletic goals. She also works with university foundations and other tax-exempt organizations that support collegiate athletics.

Josephine has deep technical knowledge related to compensation. Key areas of emphasis related to advising athletic departments and similar organizations include: benchmarking for coaches, assistant coaches, athletic directors, and staff; incentive plan design, specifically related to academic, athletic and individual coaching/athletic department performance; buy-out agreements; retention; prevalence of benefits and perquisites; deferred compensation; retirement; outside compensation; total compensation philosophy; governance; compliance
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