Pay to Play? How States Handle Signing Bonuses for Athletes

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In this edition, the authors write about the laws governing the taxation of professional athletes' signing bonuses and offer advice for tax attorneys attempting to help clients comply with those laws. The article focuses on statutes in New York, California, and Wisconsin, which account for 28 pro sports franchises.

Non-CPA sports fans (and athletes themselves) increasingly appreciate the tax aspects of luring the best free agent athletes to their teams.

One recent example is the whopper of a contract that agent Scott Boras cooked up for his client, Washington Nationals pitcher Max Scherzer. Everyone — not just the tax guys and taxpayer — could appreciate the millions in tax savings that Scherzer received by signing with the Nationals over, say, the New York Yankees, the Los Angeles Angels of Anaheim, or his former employer, the Detroit Tigers. Scherzer, a Florida resident when he signed with the Nationals, agreed to a seven-year deal worth $210 million, including a $50 million signing bonus paid over numerous years.

On top of the unique deals, state and local "jock taxes" are hot-button issues, most recently seen in two Ohio Supreme Court decisions that shook up the application and constitutionality of Cleveland's jock tax.[1]

The tax codes, regulations, and case law of different states — tagged on potential federal tax deductions — create wrinkles that muddy the true tax consequences of contracts like Scherzer's and even more vanilla versions. We've chronicled athlete residency and allocation issues in detail in this space before,[2] but this article focuses instead on the significant and sometimes tricky piece of many athletes' contracts: signing bonuses and the multistate tax compliance for athletes fortunate enough to receive them.

I. Residency Overview

An athlete's residency for tax purposes is critically important. If a taxpayer is a resident of a state with an income tax, that state is entitled to tax just one thing: everything! The media wouldn't have been nearly as excited about the tax aspects of Scherzer's recent deal if he were domiciled in a state with a robust income tax, and Scherzer probably wouldn't have been, either. So it's essential to be up on multistate residency rules and to understand that states often consider a taxpayer "resident" for income tax purposes for reasons beyond just the athlete's domicile. Whether a state's residency rules are premised on the concept of domicile,[3] statutory residency and day count tests,[4] or some other basis,[5] the first question to review is

[1] *See Hillenmeyer v. Cleveland Bd. of Rev.*, slip op. 2015-Ohio-1623 (Apr. 30, 2015); and *Saturday v. Cleveland Bd. of Rev.*, slip op. 2015-Ohio-1625 (Apr. 30, 2015).

[2] Timothy P. Noonan and Lance E. Rothenberg, "The Multistate Tax Quandary for Professional Athletes," *State Tax Notes*, Dec. 13, 2010, p. 781.

[3] In New York, the term "domicile," a critically important tax concept, isn't defined by statute. The New York State Department of Taxation and Finance's regulations, however, define a taxpayer's domicile as "the place which an individual intends to be such individual's permanent home — the place to which such individual intends to return whenever such individual may be absent." 20 NYCRR 105.20(d)(1). While common law interpretations and codified definitions of a taxpayer's domicile can vary from state to state, states across the Northeast generally share that same view that a taxpayer's domicile is his one true home — the place to which the taxpayer intends to return when away.

[4] *See, e.g.*, New York Tax Law section 605(b)(1)(B) and 20 NYCRR 105.20(a)(2) (taxpayer is New York statutory resident if taxpayer (1) maintains a permanent place of abode in New York for substantially all of the tax year, and (2) spends more than 183 days in New York during the tax year); Oregon Rev. Stat. section 316.027(1)(a) (taxpayer is Oregon statutory resident if taxpayer (1) maintains a permanent place of abode in Oregon, and (2) spends more than 200 days of the tax year in Oregon (with a caveat for taxpayers who prove they are in Oregon for a temporary or transitory purpose)); N.C. Gen. Stat. section 105-153.3(15) (in the absence of convincing proof to the contrary, an individual in North Carolina for more than 183 days during the tax year is presumed to be a resident (but absence from the state for more than 183 days does not raise a presumption of nonresidence)).

almost always: Where is the taxpayer resident? Without the advantage of being resident at the beginning of a contract in a state that doesn't have an income tax, some or all of the potential tax benefit will be lost.[6]

II. How States Apportion Signing Bonuses

We know athletes bounce around quite a bit. Players are traded, they sign free agent deals, and teams move — all kinds of events bearing on an athlete's residency occur during the course of seasons or careers. And as far as tax payments to nonresident states are concerned, there is a pretty standard set of rules that outlines how those players are supposed to allocate their regular salary income, usually on some sort of "duty day" basis.[7] Thus, it's not that unusual for athletes to have to pay tax in multiple states, even if they play only once or twice in a given tax jurisdiction. Most practitioners (and agents and athletes) seem to have grasped that issue.

The taxation of a signing bonus creates different issues — and not just because we're dealing with bigger dollars. Again, this is less of an issue in the state where an athlete lives; if the player is a resident in a state that imposes an income tax, expect that the player will pay income tax on the signing bonus in his home state.

But what about other states? And what if the player is smart enough to live in Florida, Washington, or some other state without an income tax? You might be surprised to know that there could be a different answer altogether. So a Florida-based athlete who is taxed on his regular salary in nonresident states might very well be able to avoid paying state taxes on his signing bonus. Given the large dollars now thrown around in these contracts, practitioners, agents, and the athletes themselves should be paying attention.

To see how that plays out, let's examine the issue in three states. New York, California, and Wisconsin account for 28 professional sports franchises,[8] they impose an income-based tax on nonresidents, and the income tax rates on the highest earners (such as athletes) are three of the highest in the United States. You'll notice that despite some variance in the operative laws and regulations, those three states (like several others) actually have a lot in common. You'll also notice that those states' signing bonus rules aren't necessarily just applicable to nonresident athletes who play on teams within their borders, but to nonresident athletes who play for teams all over and enter those states for various reasons.

A. New York

If we call the Giants and Jets (both of which play in New Jersey) New York teams, the Empire State boasts 10 professional sports franchises. The New York State Department of Taxation and Finance has rules bearing on the allocation of nonresident athlete income, including signing bonuses. In New York, as in other states, the duty day apportionment formula is the ordinary method of sourcing athlete service income to New York, but signing bonuses can escape that treatment. Bonuses paid for signing a contract are not considered services rendered for a professional athletic team so long as a three-part test is met:

- the payment of the bonus is not conditional on the signee playing any games for the team, performing any later services for the team, or even making the team;
- the signing bonus is payable separately from the salary and any other compensation; and
- the signing bonus is nonrefundable.[9]

The nonresident athlete's contract with a New York sports franchise — or a franchise that plays games in New York — will be subject to review in the event of an audit, but the department clearly views a true signing bonus as a separate payment received by a nonresident, not necessarily a salary received for services performed within and outside New York.

A New York court first addressed the issue of allocating a nonresident athlete's signing bonus in 1979. In *Clark v. New York State Tax Commission*,[10] the court found that a signing bonus received from the Boston Bruins by a nonresident hockey player who played part of the 1974 season with a minor league hockey team in New York was not allocable New York-source income. The court cited the following:

- the signing bonus was paid as consideration for the athlete giving up his amateur and free agent statuses, and for agreeing to become the exclusive property of the hockey club executing the contract;
- the bonus was payable separately from the salary and other compensation under terms of the contract;
- the signing bonus was nonrefundable; and
- the receipt of the signing bonus was not conditional on the taxpayer playing any games for the club or even making the team.

B. California

For a nonresident athlete who earns a signing bonus with a California team, or for a team that plays games, visits, or practices in California, the California State Board of

[5]Taxpayers can be taxed as California residents if they're in the state for other than temporary or transitory purposes (even if domiciled outside California), or if they're domiciled in California but are outside the state for temporary or transitory purposes. Cal. Rev. & Tax. Code section 17014(a)(1) and (2); Cal. Code Regs. 18, section 17014(a).

[6]When the athlete-taxpayer maintains a separate domicile from his spouse, he and his representative should also keep the implications of community property income allocation in mind, especially given that Nevada, Texas, and Washington are community property states without an income tax.

[7]*See supra* note 2.

[8]Including Major League Baseball, the National Football League, National Basketball Association, and National Hockey League (and the New York Jets, who are more aptly characterized as New Jersey's team).

[9]20 NYCRR section 132.22(b)(4)(ii).

[10]86 A.D.2d 691 (3d Dept. 1982).

Equalization says it will review the bonus and its apportionment to the state on a "case-by-case" basis — whatever that means. According to the California regulations, if services must be performed to receive or keep the signing bonuses and if any of those services are performed or partially performed in California, then the signing bonus should be in the taxpayer's compensation to be allocated within and without California.[11] This looks and smells a lot like the New York rule.

In a non-precedential BOE decision, *Matter of Testaverde*, the allocation of Vinny Testaverde's 1995 signing bonus paid by the Cleveland Browns was questioned. Testaverde, a California nonresident, signed a contract with the Browns. When the Browns played the San Diego Chargers in San Diego in 1995, he was healthy and on the roster.[12] He initially allocated a portion of his salary to California, but California wanted a more significant piece of his 1995 income, including his signing bonus, to be apportioned using the state's duty days method. The California Franchise Tax Board sought that treatment even though Testaverde's signing bonus was clearly an inducement to sign the contract with the Browns and was paid separately from his other salary.[13]

Testaverde won his California appeal, and his 1995 signing bonus wasn't apportioned to California. But his case represents the scope and complexity of these issues. Two San Francisco 49ers weren't as fortunate a few years later.[14]

C. Wisconsin

The Wisconsin Tax Appeals Commission has delivered interesting cases on the allocation of an athlete's signing bonus, dating back to the late 1980s.

Wisconsin implements a duty days formulary apportionment method, requiring athletes to source income to the state based on a fraction, with the numerator being the number of duty days spent within Wisconsin rendering services for the team, and the denominator the total number of duty days spent within and without Wisconsin. Like in New York, a nonresident athlete's signing bonus would be treated as part of "total compensation for services rendered as a matter of a professional athletic team," and thus allocable to Wisconsin unless the signing bonus:

- was not conditional on the signee playing any games for the team, performing any later services for the team, or even making the team;
- is payable separately from salary and other compensation; and
- is nonrefundable.[15]

In *Dorsey v. Wisconsin Department of Revenue*,[16] the taxpayer, Green Bay Packers linebacker John Dorsey, a Connecticut resident, was paid a $125,000 signing bonus on entering into a three-year contract with the team in 1984. The Packers originally reported a significant portion of that signing bonus as Wisconsin income on Dorsey's 1984 Form W-2. Dorsey alleged that the $125,000 was consideration he received solely for signing the contract, allocable only to his state of residence. The Department of Revenue disagreed, citing a rider to Dorsey's NFL standard player contract regarding the signing bonus income — paid separately from other salary — calling it "additional consideration for the execution of the contract above referred to and for the agreement of the player to report for play and practice with the Club, and to perform all of the things required by him to be performed under said contract." The signing bonus rider also required Dorsey to repay the signing bonus in the event that he failed to report, practice, or play, or left the Packers without the team's consent.

Despite Dorsey's assertion that the $125,000 was a "pure" signing bonus, the Wisconsin Tax Appeals Commission disagreed, noting that if Dorsey "merely signed the contract without performing the other services specified, he would not have been entitled to the bonus." The commission also pointed out that initial receipt (and subsequent retention) of the signing bonus was tied to separate conditions, the remainder of which — besides signing the contract — required the performance of personal services. In total, the commission determined that the signing bonus was an advance payment for the services agreed to be rendered under the rider to his contract and was allocable to Wisconsin.

Almost two decades later, the same issue popped back up in Wisconsin, only with new wrinkles. In *Dishman v. Wisconsin Department of Revenue*, the Tax Appeals Commission again reviewed the allocation of a nonresident athlete's

[11]Cal. Code Regs. 18, section 18662-6(f)(2); *see also Matter of Foster*, 84-SBE-159 (Nov. 14, 1984) (distinguishing a non-allocable signing bonus from a "playing bonus" subject to California formulary apportionment); *but see Matter of the Appeals of Hearst and Langham*, 2002-SBE-007, 142388, 141888 (Nov. 13, 2002) (finding signing bonuses received by two San Francisco 49ers players allocable to California under the duty days apportionment formula, in part because the players' contracts required the possible repayment of a portion of the bonus if they failed to report or practice, or left the 49ers without the team's consent. The BOE reached that result despite allegations that the contract language was boilerplate and unenforceable, finding that "the fact that the bonuses were refundable demonstrates that they actually represented compensation for services, rather than mere consideration for signing the contracts").

[12]Testaverde threw for 303 yards, one touchdown, and one interception in the losing effort. He also ran for 1 yard.

[13]*Matter of Testaverde*, 99A-0197, 89002465640 (Feb. 1, 2000) (finding the $500,000 portion of Vinny Testaverde's 1995 contract with the Cleveland Browns payable within 30 days of signing the contract to be consideration for Testaverde's execution of the contract and playing exclusively for the Browns, and thus a signing bonus not allocable under California's duty days formulary apportionment).

[14]*See Matter of the Appeals of Hearst and Langham*, 2002-SBE-007, 142388, 141888 (Nov. 13, 2002).

[15]Wis. Admin. Code Tax 2.31(3)(c)(2).

[16]WTAC, 87-I-168 (Mar. 17, 1989).

signing bonus — only this time it wasn't received by a Packer.[17] Instead, Cris Dishman was a cornerback on the Kansas City Chiefs in 2000, who held their training camp that season primarily in Wisconsin. Dishman would never play a down for the Chiefs in 2000 (he was cut before the season), but Wisconsin wanted to tax the entire bonus anyway. His problem was that the bonus was subject to a rider that made payment of the bonus refundable if he failed or refused to report, practice, or play, or left the Chiefs without the team's consent. That was enough for the appeals commission to allow it to be taxed.

III. Other States

We know what you're thinking: C'mon guys, what about the other 47 states? We'd likely blow past our word-count limit if we did that (and — with apologies to our editor — actually may have already).

But this is one area in which we might be able to assume continuity among states. In 1992 a commission of state tax authorities, chaired by then-New York Tax Commissioner James Wetzler, was formed to promulgate and adopt uniform apportionment rules for states imposing income tax on nonresident athletes.[18] And one piece of the commission's final product related to signing bonuses. Setting the stage for the prevailing view on the allocation of signing bonuses, the committee's recommendation was that bonuses

> earned as a result of play during the regular season or for participation in championship, playoff, or all-star games will be apportioned under the [duty days] formula. Signing bonuses would not be subject to apportionment under the formula if they are not conditional on playing any games for the team, are payable separately from any other compensation, and are nonrefundable.

If those three conditions were satisfied, the bonus would be apportioned to the athlete's state of residence only.[19]

And here's even more: Of the 17 other states that boast a professional sports franchise and an income tax, most dictate the allocation of signing bonuses on a similar statutory, regulatory, or policy basis.[20]

IV. Practical Thoughts and Considerations

So if you find yourself lucky enough to have one of those superstar athletes in your office for a tax consultation, keep the following things in mind when talking about signing bonuses:

- Pay close attention to the residency issues. Don't just take the athlete's word about where his "home" is. Dig as deep as you can into the residency issues to make sure a troubling residency audit isn't in his future. We've represented several athletes who have played for New York teams and unwittingly run afoul — or come close to running afoul — of New York's "statutory residency" rules. So look out for residency.
- Get a copy of the contract. Study it to understand the nuances of the signing bonus issue. As you can see from the states we've looked at, all make it clear that the actual provisions of the bonus and how it is paid are critical to understanding the tax treatment.
- Some sports are subject to collective bargaining agreements, which could be incorporated by reference in the athletes' contracts. Make sure those are reviewed as well; they are usually made available online. We don't necessarily think that there are provisions in here that could negate favorable tax treatment on signing bonuses, but those issues need to be fleshed out as well.
- If you do find offending language in a contract regarding a signing bonus — and it's not too late — see whether anything can be done about it. Sometimes leagues or teams operate off standard forms and models, and it's possible that no one has put thought into whether to structure them to maximize state tax benefits. The horror! But just because a form sets forth specific language doesn't mean that language can't be changed.
- If you have lots of clients in this area, talk to agents so they know the magnitude of this issue. Heck, show them this article. We could be talking about millions in extra cash for their clients.
- If you are an agent, or you find yourself interacting with teams or sports leagues, educate them on this as well. Again, so much of what we often see in contracts (in both the sports world and real world) comes from boilerplate agreements in which some items just haven't been given much thought. Make sure that teams know how significant some of the twists and turns in the contractual language can be.
- Finally, if you have a superstar in your office for a tax consult, get that autograph for your kid. This has nothing to do with signing bonuses, of course. But your stock at home will go up immensely if you show up after work with an autograph. ☆

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[17] 04-I-24 (May 24, 2005).

[18] Federation of Tax Administrators, "State Income Taxation of Nonresident Professional Team Athletes: A Uniform Approach," at 4 (Mar. 1994).

[19] *Id.*

[20] *See* Ariz. Admin. Code section R15-2C-604(C)(6); 35 ILCS sections 5/302(c)(1), 5/304(a)(2); Ind. Code sections 6-3-2- 2.7(a), 6-3-2-3.2; La. Admin. Code 61:I.1304(I); Maryland Admin. Release No. 24 (Sept. 1, 2008); 830 CMR section 62.5A.2(3); Mich. Rev. Bulletin 1988-48 (Sept. 27, 1988); Minn. Stat. section 290.17, subdiv. 2; N.J. Admin. Code section 18:35-5.1(b)(4)(iv)(2); 17 N.C. Admin. Code 6B.3905(a)(3)(E); Ohio's State Tax Report, No. 80 (June 1, 2006); Penn. Personal Income Tax Guide, ch. 7, p. 36 (Rev. Mar. 17, 2014); Utah Admin. R. R865-9I-44(1)(d).