

Taxation of Income on Professional Team Athletes

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## Abstract

Taxation of income for the average person can be a daunting task. However, for professional athletes, this task becomes even more tedious. Professional athletes face the jock tax. This means that athletes have to pay taxes in every state in which they play a game, practice, and perform a service that is part of their contract. Professional athletes, like every United States (U.S.) citizen, are required to pay both federal and state income taxes. Since professional athletes are constantly traveling, their state of residence becomes even more important when allocating their income to the respective state. Many question the constitutionality of the jock tax. Nonetheless, professional athletes need to strategically plan to maximize their profits, while factoring in the implementations of the jock tax.

## Taxation of Income on Professional Team Athletes

The Chicago Cubs versus the Cleveland Indians. Game 7 of the World Series. It all comes down to this *one game*. *One team* will break the drought. The other will not. Cubs fans. Indians fans. United in *one place* to watch history in the making.

The Chicago Cubs win the World Series. In 108 years, these six words have not been said in the same sentence. This most unimaginable event took place on November 2, 2016 at Progressive Field in Cleveland, Ohio. The drought was finally over. Cubs fans found hope again in their team. Everything is on the up rise in Chicago, including their state income tax revenues.

What most fans do not realize is that the Cubs players had to pay tax on their income earned while playing four of the seven games in Cleveland. In fact, all nonresident athletes that played games in Ohio had to pay taxes on their earned income. This taxation on nonresident athletes is called the jock tax and it has gotten the attention of many athletes over the past thirty to forty years. While this may seem like a straightforward concept, there are many controversies and discrepancies in regards to jock taxes among states. These controversies have led to states levying tax credits to their residents, and the formation of the Federation of Tax Administrators (FTA) Task Force in 1992. Like every other U.S. citizen, athletes are subject to paying federal income tax, in addition to paying taxes in every income-taxing state they play a game in. It is also important for athletes to establish a place of residence that will allow them to maximize their tax benefits. Not only are athletes one of the most watched and idolized groups of

people in the world, they are faced with an even greater tax burden than the average middle-class person.

### **History of the Jock Tax**

The concept of taxing a nonresident is not a new concept. In fact, the first court decision regarding taxing nonresident professional athletes was in 1976. Nonetheless, it was not until the late 1980s and early 1990s that the majority of states started to emphasize and initiate this practice (Ekmekjian, Bing, & Wilkerson, 2002). In 1991, California became the first state to impose the jock tax after the Los Angeles Lakers lost to the Chicago Bulls in the NBA Finals. Once Illinois found out what California had done, Senator John Fullerton proposed the bill entitled “Michael Jordan’s Revenge” (DiMascio, 2007; Ekmekjian, 1994). Illinois was not happy that California was taxing their famed Michael Jordan and his teammates, and they retaliated by creating a “reciprocal taxing measure that applies only to athletes from states that impose nonresident income tax on Illinois athletes” (DiMascio, 2007, p. 958). This bill was adopted July 29, 1992 and was effective for the 1992 tax year. Since Illinois saw this as a retaliation bill, they only adopted it for the states that were taxing their resident athletes (Ekmekjian, 1994; Ekmekjian, et al., 2002; Fratto, 2007). This was the start of what would become an aggressive and complex issue for athletes in the years to follow.

### **Reasons for the Rise in the Jock Tax.**

Hoffman and Hodge (2004) wrote it best, stating, “Professional athletes make tempting targets for state lawmakers because they represent a highly concentrated pool of wealth that can be taxed with little enforcement. Like other nonresidents, athletes can be

taxed by states without fear of political pressure” (p. 4). Professional athletes are now in the spotlight more so than in the past for a variety of reasons, with the two main reasons being their increase in salary and the wide availability of their schedules (Pogroszewski, 2009; Pogroszewski, 2015; Shaheen & Estes, 2012; Veliotis, 2013).

**Increased Salary.** To start, the average salary of a professional athlete has significantly increased over the years, excluding the effects of inflation. In fact, the highest paid NBA player and athlete in 1995 was Michael Jordan, who earned \$43.9 million. In 2015, the highest paid NBA player was LeBron James, who earned \$64.8 million. Over the span of 20 years, there has been an approximately 48% growth in the salaries of NBA players. This does not even compare to the approximately 231% increase among MLB players, the approximately 279% increase among NFL players, and the approximately 650% increase among boxing athletes (Badenhausen, 2015). Even though inflation is a huge factor in this steady increase, it does not take away from the fact that an athlete’s salary has risen tremendously over the years. This has provided state government with an incentive to go through the process of taxing athletes. Prior to 1991, the benefits of taxing athletes were far below the costs, and hence, most states did not bother taxing these individuals. In other words, now that athletes are being seen as a significant revenue source for states, the jock tax is being utilized in all 22 of the states that headquarter a professional team in the big four major league sport leagues (MLB, NFL, NBA, and NHL), as well as have individual state income tax (Pogroszewski, 2009). Virginia does not host a professional team; rather, it headquarters the Washington

Redskins. Since the players of the Washington Redskins would have to pay taxes in Virginia, it is represented in the table below.

| <b>States that headquarter a professional sports team &amp; impose income tax</b> |                   |               |                  |                   |
|---|-------------------|---------------|------------------|-------------------|
| 1. Oregon   | 6. Kansas         | 11. Missouri  | 16. Illinois     | 21. New Jersey    |
| 2. California   | 7. Louisiana      | 12. Minnesota | 17. Ohio         | 22. Massachusetts |
| 3. Utah   | 8. Georgia        | 13. Indiana   | 18. Pennsylvania |                   |
| 4. Arizona  | 9. North Carolina | 14. Wisconsin | 19. Maryland     |                   |
| 5. Oklahoma   | 10. Virginia      | 15. Michigan  | 20. New York     |                   |

**Easily Identifiable Locations.** With the advancements in technology, athletes are becoming more and more identifiable. With only a few clicks of a mouse, one can view an athlete's whole schedule; preseason games, exhibition games, practices, regular season games, and postseason games. Athletes cannot hide the states they will be traveling to over the course of a season. This has made it very easy for governments to calculate the amount of time spent in its respective state. Athletes are in an unfair situation since they have no control over their schedule and the states in which they will be required to travel to. "Professional athletes cannot take their business elsewhere: each professional sports league is a government-backed monopoly that decides when and where its employees will work" (Hoffman & Hodge, 2004, p. 4). Team athletes are employees of sports leagues and, as an employee, must follow the rules and regulations set forth by the league.

### **Stakeholders**

Athletes are not the only people who have to pay the jock tax. Visiting employees affiliated with a professional sport franchise are also subject to the jock tax (Shaheen &

Estes, 2012). This includes anyone who travels with a team on their away games, such as managers, coaches, trainers, equipment staff, and broadcasters. Despite earning less income than most athletes, these individuals are treated the same in regards to the taxation of their income since they are traveling from state to state as part of their contract, and are earning income (Adams, 1999).

### **Income Tax**

Income tax is a tax that is taken from a person's earned income. U.S. citizens are required to pay both federal income tax and state income taxes, assuming the person lives in a state that collects state tax. Athletes, in particular, are faced with two key issues when dealing with income tax.

#### **Nonresident Income Tax**

The first issue is "the ability of states to tax nonresidents on income earned in their state" (Pogroszewski, 2009, p. 396). Most individuals can travel from state to state and not have to worry about states taxing them on their income. For instance, delivery truck drivers travel through states on a daily basis. However, unlike athletes, they do not make as much money nor are their routes and time in each state readily available for state governments to track.

#### **States Constitutional Powers**

The second key issue that athletes face is "the states' constitutional power to tax residents on all of their personal income from whatever source derived" (Pogroszewski, 2009, p. 396-397). Many people and athletes are arguing that taxing the income of

nonresidents is unconstitutional and, therefore, should not be allowed. This argument is further examined later on.

### **Federal Income Tax**

As briefly mentioned above, athletes are subject to both federal income tax and state income tax. All U.S. citizens are required to pay these taxes if they earned enough money in the respective tax year. The Internal Revenue Service (IRS) provides citizens with the Form 1040 to file their federal income tax. This tax return is due annually on April 15. The form is straightforward, with the basic formula (Spilker, et al., 2016, p. 4-2) being:

$$\begin{array}{r}
 \text{Gross Income} \\
 \text{(For AGI Deductions)} \\
 \hline
 \text{Adjusted Gross Income} \\
 \text{(From AGI} \\
 \text{Deductions)} \\
 \hline
 \text{Taxable Income} \\
 \text{X Tax Rate \%} \\
 \hline
 \text{Income Tax Liability}
 \end{array}$$

\*AGI = Adjusted Gross Income

To understand how this formula works for professional athletes, it is important to determine what is included in each part.

### **Gross Income**

According to Section 61(a) of the Internal Revenue Code (IRC), “gross income is income from whatever source derived, including (but not limited to) ‘compensation for services, including fees, commissions, fringe benefits, and similar items’” (U.S. Department of the Treasury, 2007, p. 4). As can be seen, the IRC does not give a specific definition of what is included in gross income; rather, it is vague, stating that all income

should be included. For a professional athlete, gross income can come from a variety of sources. “The professional athlete’s portfolio of gross income includes wages, signing bonuses, performance bonuses, prize money, endorsements, royalties, license fees, personal appearance fees, gifts, and imputed interest on interest free loans” (Ekmekjian, 1994, p. 231). This means that whatever income an athlete receives, no matter the source, must be recognized as gross income. For example, Cleveland Cavalier star, LeBron James, earned approximately \$54 million from July 2015 to July 2016 in his endorsements with Nike, Kia, Samsung, Coca-Cola, among others (Packard, 2016). James would need to include this \$54 million to his gross income total for the year. Considering the high salary that most professional athletes make, their gross income can be millions of dollars. Having such a high gross income will increase the tax liability that athletes will pay.

### **For AGI Deductions**

After determining gross income, athletes need to decide what for AGI deductions they are allowed to take. Similar to the definition of gross income, the IRC does not give a specific definition for this type of AGI deductions. In other words, any expense is deductible unless there is a rule stating otherwise. For AGI deductions are more beneficial than from AGI deductions in that they reduce taxable income dollar for dollar, meaning that an athlete’s taxable income is reduced by the exact amount of for AGI deductions they have. As will be described later on, this is different than from AGI deductions, which only deduct a percentage of the expenses from taxable income. One for AGI deduction that affects athletes the most is moving expenses.

Athletes are traded to different teams constantly, sometimes even in the middle of a season. To forgo the burden of having to pay these moving expenses, the IRS has allowed athletes to deduct these amounts, dollar for dollar. According to the U.S. Department of the Treasury (2016d), there are two tests that an individual, including an athlete, must pass in order for moving expenses to qualify for a deduction.

**Distance Test.** The distance test is the first test that athletes must pass in order to qualify to deduct their moving expenses when signing with or being traded to another team. This test states that the athlete's new job location must be at least 50 miles farther than their old job location was from their former home (U.S. Department of the Treasury, 2016d). For example, when San Francisco Giants pitcher, Tim Lincecum got traded to the Los Angeles Angels in 2016, he had to move about 400 miles south. In order to pass the distance test, Lincecum's new job location (Angel Stadium of Anaheim) must be 50 miles farther than his former house in San Francisco was from his old job location (AT&T Park) in San Francisco. Since his new job location is well above the 50 miles limit, it is most probable that Lincecum passed the distance test when he was traded to the Los Angeles Angels.

**Time Test.** The time test requires that an employee work for the new employer for at least 39 weeks during the first 12 months after arriving in the new job area (U.S. Department of the Treasury, 2016d). Passing the time test is more difficult for athletes, especially since most seasons start mid-year or later, reducing the number of eligible weeks in the tax year. For instance, an NFL player who signs with a new team in the offseason may not have the ability to work in their new job location for the required 39

weeks before the end of the tax year. However, athletes can still pass this test as long as they “satisfy the time requirements as of the following year. If athletes do not fulfill the time requirements within the first twelve months after arriving in the general area of their new location, any deductions that were taken should be included as *income* [emphasis added] for the following tax year” (Pogroszewski & Smoker, 2015, p. 461). If athletes pass the distance test and the time test, their moving expenses may qualify for deductions on their federal tax return.

**Qualified Moving Expense Deductions.** According to the U.S. Department of the Treasury (2016d) in Publication 521, the overall rule regarding acceptable deductions for moving expenses is that they are “reasonable for the circumstances of [the] move” (p. 7). For example, an athlete can only deduct the travel expenses that occurred while traveling the shortest, most direct route possible. Any other stops that were made, either for sightseeing or for leisure activities, are not deductible. While listing all the acceptable and nonacceptable moving expenses would be tedious, the most prominent acceptable ones are transporting household goods and personal belongings, packing and crating belongings, lodging, shipping taxpayer’s vehicle, shipping household pet, and connecting or disconnecting utilities. Gas and oil fees can also be deducted if athletes drive their own vehicle to their new home. As with most deductible expenses, substantial evidence, such as thorough receipts and other documentation, must be provided to prove these expenses (Pogroszewski & Smoker, 2015).

**From AGI Deductions**

After subtracting the for AGI deductions from gross income, athletes now have their taxable income amount. The deductions do not stop there, however. Athletes now have the opportunity to subtract their from AGI deductions. From AGI deductions are not as beneficial as for AGI deductions since they do not decrease taxable income dollar for dollar, rather, only a percentage of the expenses may be deducted. Athletes can subtract either the standard deduction, or their itemized deductions from their taxable income, depending on which one is higher. The standard deduction amount is a preset amount that the IRS determines. Itemized deductions are recorded on the IRS form, Schedule A (Spilker, et al., 2016). Due to the high salaries of athletes and the itemized deductions salary limitations, it is difficult for athletes to have enough business expenses that can be deducted from their taxable income. Nevertheless, it is important to know the typical business expenses that professional athletes can deduct and how the IRS defines business expenses.

**Definition of Business Expenses.** According to the U.S. Department of the Treasury (2015) in Publication 535,

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your industry. A necessary expense is one that is helpful and appropriate for your trade or business.

An expense does not have to be indispensable to be considered necessary. (p.3)

An expense must be both ordinary and necessary to the business in order for it to be deductible. Since an athlete's business is to play sports, they are entitled to certain

deductible business expenses that are ordinary and necessary to perform the service of playing sports. These expenses will be recorded on Schedule A on their federal tax return. Some of the most common business expenses that athletes may face are union dues and agent fees, conditioning expenses, entertainment expenses, business suits, league fines, travel expenses, and state and local taxes (Pogroszewski & Smoker, 2015).

**Union Dues and Agent Fees.** Over the course of a season, players may be faced with fees owed to their agent. Agents are part of the business. Professional athletes may find it beneficial to have an agent represent them. This expense is unavoidable, and is an allowable deduction. Some athletes are part of their sport league union, and thus, are required to pay union dues. Since unions are also deemed ordinary and necessary to the business, athletes are allowed to itemize these fees (Pogroszewski & Smoker, 2015).

**Conditioning Expenses.** There is much debate over whether staying physically fit and in shape is part of an athlete's business, especially during the off-season. Trainer fees, tips, and gifts, club memberships, training equipment, and green fees, nutritional supplements, and hot tubs are all conditioning expenses that an athlete may incur (Pogroszewski & Smoker, 2015).

**Trainer Fees, Tips, and Gifts.** It is the trainer's job to keep an athlete in physically fit condition, in order so that they may perform their service (playing sports). Tips to a trainer are gratuitous and are expected of the athlete. Trainer fees and tips are generally deductible expenses. On the other hand, tips to trainers that are received as gifts, such as given during a holiday, have a limit of \$25. Any tip given as a gift that is over \$25 is not deductible (Pogroszewski & Smoker, 2015).

*Club Memberships, Training Equipment, and Green Fees.* According to Pogroszewski and Smoker (2015)

Expenses incurred by professional athletes in purchasing training equipment are deductible so long as they relate to an activity that the individual is undertaking in order to stay in “good physical condition” as required by his contract. If expenses relate to an activity that is considered merely entertainment or recreational in nature then they are personal and nondeductible. (p. 447)

It is extremely difficult for courts to distinguish what was done for business purposes and what was done for recreational and personal purposes in regards to exercising. The type of physical activity all depends on the sport in which athletes participate in as to whether it can be seen as strength and conditioning to their business. The athlete must keep accurate records of all expenses in order for the IRS to even consider allowing it to be deductible (Pogroszewski & Smoker, 2015).

In regards to club membership fees, section 274(a)(3)(B) prohibits a deduction “for membership in any club organized for business, pleasure, recreation, or other social purpose” (26 U.S. Code § 274, 2011a). Athletes are not allowed, under any circumstances, to deduct club membership fees (Pogroszewski & Smoker, 2015).

*Nutritional Supplements.* According to the U.S. Department of the Treasury (2016c) in Publication 502, nutritional supplements are only deductible if “recommended by a medical practitioner as treatment for a specific medical condition diagnosed by a physician” (p. 17). In order for the cost of nutritional supplements to be deductible they

have to be a true medical expense, one that a doctor prescribed. If the supplements were taken for pleasure, then they would not be deductible.

**Hot Tubs.** Hot tubs seem like an odd expense to consider when completing the Schedule A form, however, to an athlete, hot tubs may be an ordinary and necessary business expense. Of course, athletes cannot deduct the expense of a hot tub if their intended purpose is for leisure activities. Instead, athletes need to have been diagnosed with an illness or injury that requires them to use the hot tub for treatment purposes. It is only under these conditions that athletes may deduct these as medical expenses on their Schedule A (Pogroszewski & Smoker, 2015).

**Entertainment Expenses.** Generally, entertainment expenses are nondeductible since they are seen as personal and not business related. Unless athletes can demonstrate that the entertainment expenses were “directly related to the active conduct of his trade or business as a pre-condition” (Pogroszewski & Smoker, 2015, p. 451), they will not be able to deduct these expenses.

**Business Suits.** Occasionally, athletes are required to wear formal attire, purchase their own uniforms, or get a haircut. There is a clear distinction between work uniforms and business attire in the sport industry. A work uniform is the clothing that every team is required to wear while playing their respective sport. If a player is not wearing their respective uniform, they would be disqualified in playing the game. However, athletes would not be disqualified in playing a game if they do not dress up in a business suit. This is the reason why work uniforms are deductible and business suits are generally

nondeductible. Haircuts, make-up, and any other type of grooming are nondeductible as well since they are seen as personal expenses (Pogroszewski & Smoker, 2015).

**League Fines.** Athletes are often punished for their actions that go against league rules. These fines must be paid by the athletes in order for them to continue performing their service under the terms of their contract. With that in mind, courts have found that league fines are ordinary and necessary in the sport business and have deemed them deductible (Pogroszewski & Smoker, 2015).

**Travel Expenses.** The last major from AGI deduction that athletes may be able to deduct on their itemized deductions are travel expenses. Travel expenses include any expense athletes have to pay while performing any extra activities that are part of their contract. Such expenses may include the traveling to a league office to provide information or to argue a suspension. Since these are ordinary and necessary expenses, players are often allowed to deduct these expenses. It is important that players substantiate this expense with actual receipts in order to distinguish between business expenses and leisure expenses. Business expenses would be deductible, whereas leisure expenses would not be. Other traveling costs, like the cost of food, transportation, and lodging while on the road are paid by the team, so they would not be allowable travel deductions (Pogroszewski & Smoker, 2015).

**State and Local Taxes.** As mentioned earlier, all athletes are subject to the jock tax, which allows states to tax nonresident athletes on their income earned while in their state. As will be described in detail later, the total tax that athletes are forced to pay can be astronomical. Despite having to pay large amounts of taxes to other states, it increases

the chance of athletes deducting their itemized expenses, rather than taking the standard deduction.

**Itemized Deduction Limitations.** After totaling the amount of itemized expenses athletes have, they must consider the salary limitations. Athletes must complete the Itemized Deductions Worksheet if their adjusted gross income is “over \$311,300 if married filing jointly or qualifying widow(er), \$285,350 if head of household, \$259,400 if single, or \$155,650 if married filing separately” (U.S. Department of the Treasury, 2016b, p. A-13). Since most athletes’ adjusted gross income is above these thresholds, they will most likely be subject to limitations. Nonetheless, it still may be beneficial for professional athletes to reduce their adjusted gross income by their itemized deductions rather than the standard deduction if they have enough business expenses.

### **Taxable Income**

Taxable income is imperative for determining an athlete’s income tax liability. Depending on their income, this amount will be subject to a tax rate, with the highest being 39.6% (U.S. Department of the Treasury, 2016a, p. 90).

### **Credits and Prepayments**

Both credits and prepayments reduce the amount of taxes an athlete would have to pay. Each case is different, so it is important that athletes are aware of the different credits available, and are making sure that the appropriate credits are being taken.

### **Income Tax Liability**

The last item in the equation is the income tax liability. This is the final amount that athletes will either have to pay or receive a refund for. Once athletes have determined

their federal income tax liability for the year, they must now turn their attention to their state income tax liabilities.

### **State and Local Income Tax**

Every U.S. citizen is legally required to pay taxes on income earned in their state of residence and the state in which they work, or the source state. However, since the adoption of the jock tax, athletes are being faced with an even heavier tax burden than most citizens realize. States now have the constitutional powers to tax nonresident athletes on income that they earn while playing games in their state. There are two apportionment methods that states use to allocate an athlete's income. The two methods are the games played method and the duty days method.

#### **Games Played Method**

The games played method is when "compensation to an athlete is apportioned based on the ratio of games played in a particular jurisdiction to the total games played" (Krasney, 1994, p. 402). This approach looks at the number of preseason, regular season, and postseason games an athlete plays and uses that number as the denominator of the ratio. It is the job of the athlete to calculate the number of games that were played in each state where taxes are owed. The games played approach was first predominately used because of its simplicity. However, one of its disadvantages is that it does not take into consideration any other days that is included in the athlete's contract that they must perform or be in attendance. An athlete's salary encompasses more than just the game performance; they have to attend practices, meetings, all-star appearances, and press

conferences (DiFrischia, 2000; Ekmekjian, 1994; Fratto, 2007; Krasney, 1994). This is when the duty days method was greatly enforced.

### **Duty Days Method**

Unlike the games played method, the duty days method considers every aspect of an athlete's contract beyond just the game performance. According to Krasney (1994), "the duty days method allocates income using a ratio of the number of days an athlete is present in the taxing jurisdiction to the total number of days (including practice and meeting days) that the athlete is required to work" (p. 401). This method recognizes all of the athlete's contractual responsibilities, and thus, has been adopted by the majority of states and is also used in the income tax treaty between the United States and Canada and is used for IRS purposes (Adams, 1999), which will be discussed later in the International Income Tax section.

The duty days method includes "all days during the taxable year from the beginning of the professional athletic team's official preseason training period through the last game in which the team competes" (Ekmekjian, et al., 2002, p. 21). Travel days, practice days, meetings, trainings, and any other business related activity that an athlete is contractually required to perform is included in the denominator using this method (DiMascio, 2007; Ekmekjian, 1994).

**Off-Season Days.** Off-season days in which athletes are performing their contractual duties are also included. This may include "camps, instructional leagues, all-star games, team imposed training activities, and promotional events" (DiMascio, 2007, p. 960). Off-season events *must* be initiated by the team and *must* take place at the

facilities of the team. If they do not take place at the team's facility, nor are they team-imposed programs, they cannot be included in the total amount of duty days (Adams, 1999; Fratto, 2007). Also, off-season days can only be included if the contract frames it as such that "an athlete is *promising* [emphasis added] to perform in an off-season conditioning program, rather than having off-season conditioning be a condition of employment" (Fratto, 2007, p. 43). In other words, the off-season activities need to be a promise that athletes fulfill rather than an obligation that is just part of their contract. Including off-season days in the total number of duty days can be extremely beneficial to athletes since it will increase the total amount of duty days, thus decreasing the total state tax they will need to pay to each state. Athletes must be sure that their contract is structured in such a manner that they are a promise, and not a condition of their employment (Fratto, 2007).

**Travel Days.** Travel days are also included when using the duty days method. Travel days that include some type of required activity, like meetings, practices, or a game, are apportioned to the state where that activity takes place. If, however, there is no required activity on a particular travel day and it is strictly just travel, that "day will not be apportioned to any particular state, but will be included in the total number of duty days" (Adams, 1999, p. 101).

**Disabled List Days.** Adams (1999) wrote,

Days in which a team member is on the disabled list and performing no services for the team will not be apportioned to any particular state, but will be included in the total number of duty days for apportionment purposes. (p. 100).

As can be seen, the duty days approach allows athletes to maximize their total number of duty days, thereby increasing the denominator, and decreasing the amount of taxes owed to each state.

### **Signing Bonus Income**

Athletes must include most of the same income amounts in their state tax gross income as they did in its federal gross income. However, the state definition is a little different from the IRS definition of what income to include when calculating an athlete's income tax. Unlike when filing their federal tax return, athletes may not have to include signing bonuses in their income when filing their state tax returns. In order for athletes to avoid paying tax on their signing bonus, it needs to be structured in a way that does not classify it as a "reporting bonus" (Fratto, 2007, p. 45). Kara Fratto (2007) listed three conditions that must be met in order to reduce the risk of a signing bonus being classified as a reporting bonus:

1. The bonus should not be conditional upon the player providing services to the team, including playing in any games, or even making the team;
2. The bonus should be payable separately from the player's salary and any other compensation; and
3. The signing bonus should be nonrefundable. (p. 45)

Signing bonuses should be non-contingent. In other words, they should not rely upon another event taking place for the player to earn that income. If a signing bonus is contingent, it must be included in an athlete's earned income for state purposes. Also, the signing bonus should be separately paid to the athletes and should not be part of their

salary income. Lastly, the signing bonus should be nonrefundable by the team. In order for the signing bonus to be classified as a playing bonus, rather than a reporting bonus, it must be non-contingent, paid separately, and nonrefundable. Having a signing bonus classify as a playing bonus allows athletes to reduce the income that they must pay state taxes on (Fratto, 2007).

### **State of Residence**

The idea of residency is exceedingly important when determining which duty days to include in each state. Since the states have varying income tax rates, a free agent athlete may be better off choosing a team that plays in a state with a small tax rate. There are currently nine states that do not impose an individual income tax. Those states are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. The District of Columbia also does not impose an individual income tax (Shaheen & Estes, 2012). These state governments raise their revenue through other means, like through sales or excise tax.

Athletes may be residents of a state that is different from the state in which their team is headquartered. For example, an athlete may reside in Delaware, but the team is headquartered and plays in Pennsylvania. If this is the case, the athlete would pay tax on all its income in the state of Delaware, and would need to apportion its income that is earned in Pennsylvania. Athletes need to be careful not to inadvertently become a resident of another state, one of which may have a higher tax rate. Courts usually look at things like “where [an athlete’s] family is located, whether or not [they] maintain a dwelling in either place, where [they are] a registered voter, where [their] automobile is

registered, and where [their] friendships and ties to the community are strongest” (Baker, 1990, p. 27). Once athletes have established a home state, any other state that they visit is taking away from the amount of days spent in their home state, and thus, could make them a resident of another state. Athletes would need to prove that they are spending the majority of their time in their claimed state of residence and prove that they are living their normal life in that state. Athletes are nonresidents to any other state that they visit and play games in, which is important when allocating its income (Baker, 1990).

### **Income Allocation**

Once an athlete’s total income and state of residence is established, it now has to determine which nonresident states to allocate its income to. For this process, athletes need to determine how many days they spent in each state, using the guidelines mentioned above. Once they have determined the duty days allocated to each state, they must divide that number by the total number of duty days. This will give the athlete the percentage of days spent in that respective state. Next, the athlete will need to fill out that particular state’s income tax return and follow the steps to determine their income tax liability for that state. Each state’s tax form is different. Some states allow different exemptions and credits, while others do not. Nonetheless, in retrospect, athletes would multiply their total income by the percentage that they got using the duty days ratio. After determining how much income to allocate to that state, the athlete would then multiply that number by the state’s individual income tax rate (Ekmekjian, 1994). The benefit of having to pay state taxes to many states is that an athlete will be able to deduct this expense on its federal tax return on Schedule A. As previously described, paying an

enormous amount of state taxes may qualify athletes to deduct their itemized deductions, rather than taking the standard deduction.

To understand how to calculate the tax liability an athlete owes to a particular state, it is important to look at an example. Hunter Pence is an outfielder for the San Francisco Giants. He currently resides in San Francisco, making California both his state of residence and his source state. Pence will allocate 100% of his earned income to California. However, Pence must also allocate his income to the 13 other states that the Giants played in during the 2016 season. The Giants played their away games in Arizona, Colorado, Florida, Georgia, Illinois, Massachusetts, Missouri, New York, Ohio, Pennsylvania, Washington D.C. and Wisconsin. Since Florida and Washington D.C. do not impose an individual income tax, Pence would not have to file a tax return in those jurisdictions. Including exhibition games, spring training, travel days, regular season games, and postseason games, Pence had a total of 225 duty days, 11 of which were allocated to Colorado. Pence should allocate 4.89% ( $11 \text{ Colorado days} / 225 \text{ total duty days}$ ) of his \$18.5 million salary income to Colorado (\$904,444). Colorado's state tax rate is 4.63%. After Pence multiplies \$904,444 by 4.63%, he is left with an income tax liability of about \$41,876 in Colorado. Despite having such a high tax liability in just one state, Pence will be able to deduct this amount on his federal tax return. Keep in mind that this is a simplistic example of the duty days method. Realistically, there are many other variances that can affect this number, such as signing bonus income, credits, travel days interpretations, and other sources of income that were not included in this example.

**City & Local Taxes**

Not only are athletes subject to state taxes, they may also be subject to city and local taxes. Some cities tax their residents in addition to the tax they have to pay to the state. This provides the cities with additional income that they can use to improve the city, whether that is through road improvements or construction of a new building. When athletes play in prominent cities like Baltimore, Cleveland, Detroit, New York City, Philadelphia, and St. Louis, they will also have to pay an additional tax, along with the income tax to their respective states (Alm, Kaempfer, & Sennoga, 2012; DiMascio, 2007).

**Tax Credits**

After going through an example, it is clear that double taxation is an apparent issue with the jock tax. Income is taxed twice: once in the athlete's state of residence and again when the income is allocated to the individual states. Some states have adopted a solution to this issue, and that is in the form of a tax credit. "All fourteen states that have residential tax on personal income while taxing the apportioned income earned by nonresidents within their state also provide a tax credit for their residents for taxes paid to another state" (Pogroszewski, 2009, p. 408). In other words, every state that has a major league sport franchise that taxes both resident and nonresident athletes rewards tax credits to its residents.

**Restrictions**

States may have different restrictions on the tax credits they give out; however, the most common one is "to base the credit for taxes paid to another state on the amount

of income derived from sources within that state. The credit is limited to the tax rate of the state of residence” (DiFrischia, 2000, p. 122). Stated differently, the credit is limited to the amount of taxes an athlete pays to the resident state, regardless of the actual amount paid to the nonresident state. “Anything over that percentage will still be owed to the nonresident state” (Adams, 1999, p. 98). In theory, this restriction makes sense. The state of residence does not want to pay out more than what they will be bringing in. This would make them realize a loss, which would defeat the purpose of taxing athletes in the first place.

However, there are cases when this restriction is detrimental to a state. For instance, Illinois has one of the lowest income tax rates at 3.75%. Going back to the introduction, when a Chicago Cubs player plays in a state with a high tax rate, like California (13.3%), Illinois will have to give a full credit (3.75%) to all of their players for their taxes paid in California. This leaves Illinois with no profit since they had to pay back all their players with their income from taxing nonresidents. On the other hand, if a San Francisco Giants player, like Hunter Pence, played in Illinois, California would only have to pay back their players a maximum of the full amount they paid to Illinois (3.75%). This means, for the state of California, they will be able to make a profit from the difference between what residents pay and what resident athletes pay to Illinois (9.55%; Pogroszewski, 2009). For example, Hunter Pence had an approximate Illinois tax liability of \$21,583 (see calculation below) in 2016. Since Pence is a resident of California, whose tax rate is higher than Illinois, Pence will receive a full tax credit of \$21,581. On the other hand, Chicago Cubs player, Jon Lester, had an approximate

California tax liability of \$405,147 (see calculation below). However, since Lester's state residence of Illinois has a lower tax rate, Lester will only receive a tax credit of \$114,233 (3.75%), a \$290,914 difference. In other words, Lester will have to pay out-of-pocket 9.55% of the 13.3% tax rate (\$290,914) on his income earned in California, whereas Pence would not have to pay anything out-of-pocket to Illinois, since he will receive a full tax credit from his state of residence.

|   | Hunter Pence (CA) | Jon Lester (IL) |
|---|-------------------|-----------------|
| Salary                                      | \$ 18,500,000     | \$ 25,000,000   |
| Duty days in opposing state                 | 7                 | 29              |
| Total number of duty days                   | 225               | 238             |
| % of income allocated to opposing state     | 3.11%             | 12.18%          |
| Income allocated to opposing state          | \$ 575,556        | \$ 3,046,218    |
| Tax rate of opposing state                  | 3.75%             | 13.30%          |
| Taxes paid to opposing state                | \$ 21,583         | \$ 405,147      |
| Tax credit received from state of residence | \$ 21,583         | \$ 114,233      |
| Out-of-pocket taxes paid to opposing state  | \$ -              | \$ 290,914      |

Even though this restriction may be beneficial to the state, it is not beneficial to the athlete. Athletes only get a credit for the income that is below their resident state's tax rate. If their state of residence has a low tax rate, athletes will be taxed twice on some of their income.

### **Reciprocal Agreements**

To try to alleviate the burden for the residents who live in a state with a small income tax rate, some states have entered into reciprocal agreements with other states. Reciprocal agreements "allow the taxation of all income of a resident of one of the states that is a party to the agreement and earned in either of the states to be taxed in the taxpayer's state of residence" (Adams, 1999, p.98). In other words, the states that enter

into reciprocal agreements do not tax the athletes whose residence is in the other states in the agreement. It is a mutual agreement not to tax each other's residents. For instance, Pennsylvania has a reciprocal agreement with New Jersey, Maryland, Indiana, Ohio, Virginia, and West Virginia (TurboTax, 2016). This means for any player that resides in Pennsylvania and plays a team in any of these six states, they will not be subject to pay income tax in that state.

### **International Income Tax**

There are 7 NHL teams, 1 NBA team, and 1 MLB team that are headquartered in a country other than the United States. These 9 teams play all of their home games in Canada and, therefore, are subject to Canada income tax rules and regulations. Not all athletes that play for these teams, however, reside in Canada. Some players still reside in the United States and travel to Canada only for the season. Some players reside in Canada and play in the United States. The United States and Canada have different income tax rules and regulations that athletes must be aware of when determining their place of residence and when filing their tax returns.

### **Country of Residence**

The idea of residency is evermore so important when it comes to international income tax regulations. Depending on where an athlete resides will determine what country's income tax laws they have to abide by. Nevertheless, all U.S. citizens are taxed on their worldwide income (Berry, 2002). This means that even if athletes are deemed a U.S. citizen, but play games in Canada, they must pay taxes on all of their income, both earned in the U.S. and in Canada, to the United States.

**United States Residency.** A nonresident of the United States may be classified as a resident for tax purposes based on two tests described in IRC section 7701(b). The two tests are the green card test and the substantial presence test (26 U.S. Code § 7701, 2011).

**Green Card Test.** “Under the IRC, an individual who holds or applies for an alien registration card – a ‘green card’ – during the calendar year attains [United States] resident status” (Adams, 1999, p. 86). This means that any player that has a green card is seen as a resident of the United States. However, obtaining a green card can be a daunting and extensive task for foreign athletes. As a substitute method, they may apply for a temporary work permit, which allows them to work in the United States for up to one year (Adams, 1999). Since most foreign athletes do not take the time to obtain a green card, the second test, the substantial presence test, is used most often.

**Substantial Presence Test.** According to IRC section 7701(b)(3), athletes meet the substantial presence test if they are “present in the United States on at least 31 days during the calendar year *and* [emphasis added] the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years ... equals or exceeds 183 days” (26 U.S. Code § 7701, 2011). To determine the amount of days in the United States for the current year and the 2 preceding years, the athlete needs to multiply the 1<sup>st</sup> preceding year’s amount of days by  $\frac{1}{3}$ , and the 2<sup>nd</sup> preceding year’s amount of days by  $\frac{1}{6}$ . Every day spent in the United States in the current year counts as one full day. If athletes fail to come up with a presence of 183 days or more in the United States, they will not be considered a resident

of the United States. Adams (1999) brilliantly sums up the substantial presence test when he wrote,

When an athlete is present in the United States for less than 183 days during the calendar year, has a closer connection to a single foreign country than to the United States, has a tax home for the entire calendar year which is located in the same foreign country for which a closer connection is claimed, and is not currently taking steps to become a lawful permanent resident, that individual will not be considered a resident under the substantial presence test. (p. 87)

**Canada Residency.** “Athletes who are U.S. citizens playing for Canadian based teams must ensure they do not end up paying taxes to Canada on their worldwide income because it will be subject to a higher tax rate than in the United States” (Fratto, 2007, p. 37). There are four ways to determine residency in Canada: full-time resident, ordinarily resident, deemed resident, or part-time resident.

**Full-Time Resident.** If athletes have a continual connection and relationship with Canada and have a personal dwelling that their spouse or dependents reside in for a year, they are deemed to be a full-time resident of Canada and must apply to the Canadian income tax laws (Adams, 1999; Fratto, 2007).

**Ordinarily Resident.** Courts look at an athlete’s personal habits and routines when determining if they are an ordinarily resident of Canada. They also look at the length of time they spent and the activities they did while in Canada. If courts find that an athlete has a place in Canada where “in the settled routine of [their] life, [they] regularly,

normally, or customarily lives” (Adams, 1999, p. 82), they will be considered an ordinarily resident.

***Deemed Resident.*** In order to be a deemed resident, an athlete must be temporarily present in Canada for at least 183 days of the calendar year. Also, the athlete must be “a resident in another country for the other 183 (or more) days in question” (Adams, 1999, p. 82).

***Part-Time Resident.*** The last method of deciding if athletes are a resident of Canada is whether they are deemed a part-time resident. If an athlete has connections with Canada, other than being temporarily present, and establishes significant residential ties, they will be deemed a part-time resident and will be taxed on income starting from the day the athlete entered Canada (Adams, 1999; Fratto, 2007).

### **United States Taxation**

As mentioned already, the United States taxes their citizens on all worldwide income. Any income that athletes earn, while playing in both the U.S. and in Canada, is subject to U.S. income tax if they are deemed a U.S. citizen. Once an athlete determines that it is a U.S. citizen, most of the rules, methods, and approaches previously described are used. They must appropriately allocate their income using the duty days method, including days spent in Canada (Berry, 2002).

### **Canada Taxation**

Like the United States, Canada taxes individuals on their worldwide income. Each Canadian province taxes their residents using a fixed percentage of their federal tax payable. Even though these rates vary, the standard provincial rate is 52% (Adams,

1999). Since both countries tax an athlete's worldwide income, nonresidents of Canada who play games in Canada are subject to the issue of double taxation.

In order to eliminate the possible double taxation on income taxed in the U.S. and Canada, a Bi-Lateral Tax Treaty was formed between the two countries. This treaty "removes the burden of double taxation by providing that an athlete's income will be taxable only in the country where the athlete's services are performed" (Fratto, 2007, p. 36). This treaty is similar to the tax credits given by some of the states, in that its main purpose is to eliminate double taxation. An athlete "is subject to Canadian tax on his business profits only to the extent that these are attributable to a permanent establishment in Canada" (Adams, 1999, p. 84). This means that athletes are only subject to tax on the income earned in Canada, and not their worldwide income.

### **Is the Jock Tax Fair?**

With the stress of filing what could be over 20 state tax returns, and the complications of double taxation, many people are left wondering if the jock is fair and constitutional. Every state's different rules and regulations made filing tax returns that much more difficult for athletes. In June 1992, the Federation of Tax Administrators (FTA) formed a task force to help with these issues and to try to bring a more uniform approach to taxing nonresident athletes (Pogroszewski, 2009).

### **Arguments for the Jock Tax**

One of the few arguments for the jock tax is that athletes should be taxed more because they make more money than the average person. States should be able to capitalize on this stream of extra cash flow, one that they did not have decades ago

(Shaheen & Estes, 2012). While the jock tax may bring in extra revenue for the states, that is about the only positive that people have found in regards to the jock tax.

### **Arguments against the Jock Tax**

Athletes do not like the jock tax because it means that they, or their personal finance manager, have to file multiple tax returns every year. Not only is this a tedious and long process, athletes also have to comply with all the different tax rules of each state. Another reason athletes do not like the jock tax is that it opens them to the possibility of being double taxed on their income. As discussed throughout the paper, athletes pay taxes on 100% of their income to their state of residence, in addition to every other state that they play in.

There are four key legal and constitutional concerns that people have expressed regarding the jock tax (Krasney, 1994; Shaheen & Estes, 2012). These four concerns deal with the Equal Protection Clause, the Privileges and Immunities Clause, the Due Process Clause, and the Commerce Clause.

**Equal Protection Clause.** Under the Equal Protection Clause of the 14<sup>th</sup> Amendment, no state “shall deny to any person within its jurisdiction the equal protection of the laws” (U.S. Const. amend. XIV, §1). Nonresident athletes feel as if they are being treated differently than residents. In other words, they feel as if their rights are not being protected and that they are being discriminated against. Courts have argued back in stating that “the principle that the Equal Protection Clause requires only that the classification rationally further a legitimate state interest” (Krasney, 1994, p. 409). As

long as the states can prove that they considered the interest of and relationship with nonresidents, they have not gone against the Equal Protection Clause.

**Privileges and Immunities Clause.** Similar to the Equal Protection Clause, the Privileges and Immunities Clause deals with athletes feeling discriminated against. This clause “assures fair treatment of citizens of other states” (Krasney, 1994, p. 409). States only need to prove that they have not made any distinction between the treatment of residents and nonresidents. Discrimination of the fact that the athletes are citizens of another state is not enough to violate this clause (Krasney, 1994).

**Due Process Clause.** The Due Process Clause of the 14<sup>th</sup> Amendment has “three restrictions on the states’ power to tax income from interstate activities” (Krasney, 1994, p. 410). The first limitation is the athlete must have at least minimal contact or connection with the state in question. “A nonresident individual or corporation must bear only its fair share of cost of the local government whose protection it enjoys, and that the nonresident individual or corporation must receive something from the state being asked to give compensation” (Krasney, 1994, p. 410-411). The only argument that states will need to prove in regards to the Due Process Clause is that the tax that the athlete owes is paying for the opportunities, benefits, and protection that the state offered when the athlete was in its state (Krasney, 1994).

**The Commerce Clause.** The last constitutional clause that athletes have tried to use to forbid and overturn the jock tax is the Commerce Clause. The Commerce Clause gives Congress the power to regulate commerce among the states (Krasney, 1994). Athletes have argued that they do not have substantial nexus with the other states that

they play their games in. They are only there for a few days, and then they leave. They argue that this does not give the states the authority to tax them based on the little time spent in the state. According to Krasney (1994), however,

A tax will be sustained as long as it (1) is applied to an activity with a “substantial nexus” with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. (p.413)

With this in mind, it is rare to find a case where an athlete was able to prove that a state has gone against the Commerce Clause. Despite many attempts to prove otherwise, courts and states have not been able to justify their reasons for taxing nonresident athletes (Ekmekjian, et al., 2002; Shaheen & Estes, 2012). Now that athletes know that the jock tax is not going away, the FTA’s task force tried to come up with a more uniform approach.

### **A Move to Uniformity**

The cause for the formation of the FTA’s task force came from constant complaints and expressed frustrations of then Kansas City Chiefs owner Lamar Hunt. “The frustration and discontent with the inconsistency led [him] to approach the FTA with a plea for the development of a consistent and more uniform approach. In response, the FTA created a Task Force to help solve the problem” (DiMascio, 2007, p. 962). Various states and the four major league player associations all provide input to the task force (Pogroszewski, 2009). In 1994, the task force made four recommendations for a more uniform approach, upon hearing the complaints and disagreements among states

about the taxation of nonresident professional athletes. Two of the recommendations pertain to a uniform approach to the allocation of income and the other two recommendations deal with a simplified means of filing tax returns (Adams, 1999; DiFrischia, 2000).

**Home State Apportionment Formula.** Under this method, “all of an athlete’s earnings would be apportioned to the state in which [their] home games were played” (DiFrischia, 2000, p. 126). At first, many states approved of this more uniformed method because it was simplified and would only require athletes to file one or two tax returns. This method would also ease the burden of having to follow the rules and regulations of every state and, thus, the issue of double taxation would be eliminated. As many states soon realized, this formula violated many of the constitutional rights previously described, so the FTA task force recommended another method, which was the Uniform Apportionment Method (Adams, 1999; DiFrischia, 2000).

**Uniform Apportionment Method.** “A significant goal of the Uniform Apportionment formula [was] to allocate each athlete’s income in some consistent manner between the athlete’s home state and the nonresident state” (DiFrischia, 2000, p. 127). Adopting this method would decrease the compliance burden that athletes are faced with. To go along with this new idea, the FTA task force recommended that all states eliminate the games played method and all use the duty days method, as described earlier. Despite virtually all states adopting the duty days method, states still “utilize different tax rates, credits, exemptions, allocation formulas, residency requirements, compliance

procedures, and filing deadlines” (DiFrischia, 2000, p. 127). This method was favored the most, however, it was not fully implemented among states.

**Base State Model.** In order to try to resolve the issue of having to file multiple tax returns, the FTA task force recommended two models: the Base State Model and the Partnership Model. Under the Base State Model, “a nonresident professional athlete would have to file a return in his team’s state of domicile” (DiFrischia, 2000, p. 128). The burden of filing multiple tax returns falls on the state, rather than the individual. The athlete would no longer need to allocate the correct income to each state, as that would now be the job of their state of residence. Even though this sounded great for the athletes, states did not want the burden to fall on them, so this model was never really used (DiFrischia, 2000).

**Partnership Model.** The last recommendation of the FTA task force was the Partnership Model, which says that the “filing responsibilities would be met through a single, annual filing by the team on behalf of all eligible team members” (DiFrischia, 2000, p. 128). Similar to the Base State Model, teams did not want the burden of filing a unified tax return on them, so this recommendation was never put into practice. Despite the effort of the FTA task force, no truly uniform approach has been adopted by all states, and athletes are still hoping that one day, paying their state income taxes will be easier and more convenient (DiFrischia, 2000).

### **Conclusion**

It is hard for athletes to hide from the magnifying glass that is always on them by the government. In regards to state income tax, professional athletes are held to a much

higher standard than most individuals, due to their increased salaries and schedule availability. Like every U.S. citizen, professional athletes are required to file both a federal income tax return and a state tax return. Professional athletes have specific federal deductions and business expenses that they may be able to use to reduce their taxable income, some of which include union dues, trainer fees and tips, and training equipment costs. However, for athletes, filing their state taxes can become a daunting task due to the jock tax that most states impose on nonresidents. Nonresidents are required to pay income tax in every state where their team plays their games. The residency state of professional athletes is important as it establishes to which state they must allocate all of their worldwide income. There are two common methods that states use in order to allocate a professional athlete's income: games played method and the duty days method. Despite the failed attempts to a more uniform approach by the FTA's task force, most states have adopted the duty days method as their allocating method.

Teams headquartered in Canada are faced with even more complications due to the possibility of two country's rules and regulations to deal with. Because of this issue, the United States and Canada have created the Bi-Lateral Tax Treaty that may exempt some athletes from having to pay taxes in Canada. The jock tax has been confronted with much criticism over the years, which led to the FTA task force trying to create a uniform approach among states. Even though no uniform approach is being used, the jock tax is showing signs of simplicity for the future. All professional athletes are looking forward to that day.

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