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# Tax Planning for Incoming Professional Team Athletes

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# Tax planning for incoming professional team athletes

by Dr. John E. Karaffa<sup>1</sup> CPA/PFS, CFP® of ProSport CPA PLLC

## Introduction

Little doubt exists about the resolve of the United States government towards its tax collection and enforcement efforts aimed at foreign professional athletes. Just ask Brazilian IndyCar driver Helio Castroneves and South African golfer Retief Goosen<sup>2</sup> about their high-profile tangles with the Internal Revenue Service (IRS) in the past year. In fact, the IRS has instituted a task force, called an Issue Management Team, which focuses exclusively on “improving U.S. income reporting and tax payment compliance by foreign athletes and entertainers who work in the United States.”<sup>3</sup>

The IRS initiative aims to improve the guidance for these individuals, to provide enforcement personnel with the information they need to deal with this group, and to conduct direct compliance and enforcement activities.<sup>4</sup>

In these days of an ever-growing U.S. national debt and the government’s immediate need to secure additional sources of funding, it is no wonder why such revenue accretive initiatives have taken a heightened importance in the IRS. Professional athletes from overseas should take notice.

This article focuses on the general features of U.S. tax law, the taxation of foreign professional athletes, and tax-planning considerations.

## General features of U.S. tax law

Taxpayers in the U.S. assess their own tax liabilities and pay taxes voluntarily through a system of self-assessment.<sup>5</sup> Effective compliance with such a self-assessment system requires that taxpayers make a good-faith effort to meet their tax obligations.<sup>6</sup>

## *Resident alien or nonresident alien determination*

The United States Internal Revenue Code’s (IRC) tax treatment of foreign persons depends on whether an individual is considered a resident or a nonresident. The description utilized in the IRC for such foreign individuals is the term alien, which refers to “any individual who is not a U.S. citizen or U.S. national.”<sup>7</sup>

Resident aliens are subject to taxes in the same manner as U.S. citizens: They are subjected to tax on all of their income, regardless of type and origin of the income.<sup>8</sup> Nonresident aliens are taxed generally on U.S. source income either effectively connected with a U.S. trade or business and certain kinds of fixed, determinable, annual, or periodical income.<sup>9</sup> Nonresident aliens are aliens who have not passed either the Green Card Test or the Substantial Presence Test:<sup>10</sup>

### – *Green Card Test*

Foreign nationals who at any time during a year are “lawful permanent residents of the United States according to the immigration laws, and this status has not been rescinded or administratively or judicially determined to have been abandoned”, are considered green card holders, and thus, meet the Green Card Test.<sup>11</sup>

### – *Substantial Presence Test*

Foreign nationals in the United States are considered residents for tax purposes if they meet the Substantial Presence Test. To meet this test, they must be physically present in the U.S. on at least 31 days during the current year, and 183 days during the three-year period that includes the current year and the two years immediately before that. The prior two years counts all the days present in the current year, and one-third of the days present in the first year be-

fore the current year, and one-sixth of the days present in the second year before the current year.<sup>12</sup>

Foreign professional athletes participating on a team in the major sporting leagues in the United States will most likely meet the Substantial Presence Test, and thus they will be treated as resident aliens. Visiting sportsmen will likely meet neither the Green Card Test nor the Substantial Presence Test, and therefore, they will usually fall under the rules for the U.S. taxation of nonresident aliens.

## Taxation of foreign professional athletes

### *Nonresident alien professional athletes*

Foreign professional athletes qualifying as nonresident aliens would likely consist of non-team-sport athletes such as:

- golfers,
- tennis players,
- race car drivers,
- fighters, and
- track and field athletes.

These professional athletes would likely not meet the Green Card Test and the Substantial Presence Test, and therefore, they would be subjected to rules pertaining to nonresident alien taxation.

Nonresident aliens are taxed generally on effectively connected income (ECI) with a U.S. trade or business and certain kinds of fixed, determinable, annual, or periodical (FDAP) income.<sup>13</sup> All income from U.S. sources that is connected with the conduct of a trade or business in the U.S. is considered effectively connected income and is taxed at the regular graduated income tax rates.<sup>14</sup> Income earned as the result of a foreign professional athlete’s participation

in a sporting event would be considered the performance of personal services and, therefore, would qualify as ECI.

FDAP income refers to all income, except for gains derived from the sale of real property and items excluded from gross income, such as municipal tax-exempt or qualified scholarship income.<sup>15</sup>

Examples of FDAP income that nonresident professional athletes might earn from U.S. sources would include interest and dividend income, rents, royalties, commissions, prize money, and fight purses.<sup>16</sup> Non-ECI income, such as investment income, is taxed at a flat 30% tax rate or a lower treaty rate, if applicable.

### *Income tax treaties*

A key point to investigate with regard to the taxation of foreign professional athletes is to ascertain whether or not an income tax treaty exists between the United States and the foreign country of residence.<sup>17</sup> Under tax treaties, provisions are included that allow foreign persons to be taxed at reduced rates or exempt from taxes on certain items of income they receive from U.S. sources.<sup>18</sup>

Of particular note, most of the tax treaties explicitly provide guidance to professional athletes in a section labeled something similar to "Artists and Athletes". For example, the *Convention between the United States and the United Kingdom* contains Article 16, "Entertainers and Sportsmen", which provides an exemption of U.S. taxation for United Kingdom residents on up to \$ 20,000 of personal service income earned in the United States.<sup>19</sup> This treaty exemption would overrule the prevailing IRC, and thus, invocation of this treaty position would allow the income to be nontaxable in the United States.

The income tax treaties vary from country to country, so it is important to carefully review the applicable country's tax treaty to understand its provisions affecting professional athletes performing services in the United States.

### *Resident alien professional athletes*

Professional athletes likely qualifying as resident aliens, due to the length of their playing seasons, would consist of team-sport athletes such as those participating in the following U.S. professional sporting leagues:

- National Football League (NFL),
- National Basketball Association (NBA),
- Major League Baseball (MLB),
- National Hockey League (NHL), and
- Major League Soccer (MLS).

These professional athletes would likely meet one or both of the Green Card Test and the Substantial Presence Test, and therefore, they would be subjected to resident alien taxation.

Resident aliens are taxed in the same manner as U.S. citizens. All income, regardless of source, must be reported on a U.S. tax return for a resident alien. Worldwide income is subject to taxation at graduated income tax rates, and deductions, exemptions and credits are allowed in the same manner as for U.S. citizens. Additionally, various filing statuses are available. Tax returns are due by April 15 of the year following the applicable calendar year.<sup>20</sup>

### *Other taxes*

#### *States and cities*

In addition to and distinct from U.S. taxes levied at the Federal level, states, cities and localities may levy and collect taxes. Each jurisdiction is autonomous from one another and from the federal government and each administers its revenue collection efforts independently of the other taxing entities. Each state, city and county has different regulations affecting the amounts and amount allowable for exemptions, deductions and credits. Tax rates also differ between jurisdictions. Many states, cities and counties have no income tax and raise revenue from its residents through other types of taxes and fees levied on real estate, automobiles and other personal property. Tennessee, for example, does not have a traditional income tax; however, the state does levy tax on individuals and other entities receiving certain types of interest and dividend income.<sup>21</sup>

Similar to U.S. tax laws concerning a taxpayer's residency status, states also distinguish between whether a taxpayer is a resident, part-year resident or nonresident. A resident for U.S. tax purposes may not necessarily be considered a resident for state taxes, depending on the facts and circumstances of each case. Generally, residents of a state are subjected to tax on their worldwide income earned during their period of residency, which may be only portion of a calendar year.

Nonresidents of states are generally taxed only on income earned from sources within the nonresident state. The underlying premise that states rely on is that a portion of a professional athlete's salary is earned performing services through their athletic competition in the various jurisdictions around the country, and therefore, taxes are calculated based on the income allocated to each venue.

For professional athletes, the apportionment of income to be allocated to any particular jurisdiction depends on the rules of the states. Most often, the states require the usage of a formulaic approach, allocating income to states based on a proportion of the number of days on duty in a particular state versus the total number of duty days in a year. For example, Utah defines duty days as:

*"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 or is scheduled to compete."*<sup>22</sup>

Some jurisdictions, such as the city of Cleveland, Ohio, require that income be allocated based on the ratio of the number of games played in the jurisdiction versus the total number of games played.<sup>23</sup> The laws vary widely in the many states, cities and localities in which a professional athlete competes.

### *Social security and medicare*

In addition to U.S., state, city and local income taxes, social insurance taxes are levied on compensation received in the United States. Social Security, the short name for the Old Age, Survivors and Disability Insurance (OASDI) program, originated in 1935 through the passage of the Social Security Act.<sup>24</sup> For 2012, employees currently contribute 4.2% of the first \$ 110,110 of their compensation towards Social Security. Historically, 6.2% has been the employee's required rate of contribution towards Social Security. Additionally, employees must contribute 1.45% of their entire compensation towards Medicare, a health insurance program. Employers must make matching contributions of 6.2% and 1.45% for Social Security and Medicare on behalf of their employees.<sup>25</sup> Self-employed residents are subject to Social Security and Medicare taxes, up to 13.3% (both the employer and the employee portions).

Nonresident aliens are exempt from Social Security and Medicare taxes on their self-employment earnings.

An important point to note with regard to Social Security and Medicare is that the United States has entered into Totalization Agreements with several countries as a means to improve "Social Security protection for people who work or have worked in both countries."<sup>26</sup> Totalization Agreements prevent an employee from having to pay social taxes in both his home and foreign countries on the same income. Additionally, these agreements enable the employee to aggregate contributions credits made into one country's social system with the other country's contributions, thus maximizing the total eligible benefit earned in the home country's social security system.

### Tax planning considerations

Appropriate tax planning with the assistance of qualified tax professionals is essential to minimize the tax burden borne by foreign professional athletes. The tax regulations for foreign nationals are complex and evolving as the result of legislative changes continually being made to the Internal Revenue Code. The unavoidable portion of the facts and circumstances of a professional athlete's immigration to the U.S. may dictate the tax treatment to be expected; however, some planning opportunities should be considered.

#### Residency determination

Whether an alien is a resident or nonresident for income tax purposes is a very important distinction, which was discussed earlier. For professional team athletes, resident alien status is often the de facto filing position, based on the length of time spent in the United States during the sports season. However, for foreign professional athletes who participate in a partial season or whose season overlaps two calendar years, such as players in the NBA and NHL, the players may be able to utilize nonresident alien taxation because of the limited number of days spent during the year of arrival to the United States.

#### Residency election

It may prove beneficial for a married foreign professional athlete to make a special election on the tax return that allows the personal exemption for the spouse,

the use of standard deductions instead of itemizing deductions, and the ability to be subjected to the beneficial married-filing-joint income tax rates. If this election is made, then both the taxpayer and spouse are treated as residents for the entire taxable year, worldwide income for the entire year is subjected to tax and treaty benefits cannot be invoked.<sup>27</sup>

#### State selection

Foreign professional athletes who receive offers from multiple teams should take state income taxes into consideration as part of their evaluation process. State income taxes vary widely, from California's top rate of more than 10% (9.3% individual income tax rate, plus an additional 1% surtax on incomes of more than \$ 1 million<sup>28</sup>), to Florida, Texas and Washington, which have no income tax.

#### Assignment timing

Foreign professional athletes may have the opportunity to dictate when they arrive in the United States for their professional sports season, as well as when they depart. Arrival and departure may be dictated by team requirements, schedules such as school terms, or simply personal choice.

Leaving one location during certain parts of a tax year may allow for the maximization of full-year standard deductions, exemptions, credits and tax rates in the country of departure, the country of arrival, or both, depending on the facts and circumstances. It may be possible to split income among the countries involved, so that only a portion of the income is taxed in each location, thus triggering the lower brackets of the marginal tax rates in each country. The day count may play an important role in evaluating the timing of a foreign assignment. The tax impacts of various scenarios would need to be calculated to ascertain the optimum tax planning surrounding immigration or expatriation.

#### Income and deduction timing

##### Tax rate arbitrage

Immigration to the United States may present substantial tax-planning opportunities, especially when the foreign country's tax rates are higher than that of the United States. The taxpayer may be able to reduce home-country taxes while increasing U.S. taxes, or vice versa, thus lowering the overall worldwide income

tax burden. Coordination between the U.S. tax professional and foreign country tax preparer is advised, so that the tax rules in both countries can be leveraged to optimize the ultimate tax liability borne by the foreign professional athlete.

#### Income

Income earned by a professional athlete is taxed when received. If the foreign country's tax rate is lower than that in the U.S., then it may be advisable to accelerate the receipt of income in the foreign country, so that it is received before residency is established in the United States.

#### Capital gains

Sales of certain assets may provide substantial planning opportunities for foreign professional athletes. For example, a limited exclusion from taxation exists for the sale of a principal residence. Up to \$ 500,000 of capital gain is eligible for tax-free treatment for a married couple, assuming that the taxpayers owned and used the home as a principal residence for two out of the five years before the sale and that the taxpayers have not "excluded gain on another home sold during the two years before the current sale."<sup>29</sup>

Sales of other capital assets may avoid U.S. taxation, and potentially also foreign country taxation, if the capital sales are made by a nonresident alien after the departure from the foreign country and during a year when the nonresident alien was not present in the United States more than 183 days.

#### Expenses

Expenses incurred by a professional athlete are deductible when paid. If the foreign country's tax rate is lower than that in the United States, then it may be advisable to delay the payment of expenses, so that they are paid after residency is established in the United States. It is also possible that potential expenses incurred are deductible in the United States, but not the foreign country, and vice versa. An analysis would be needed to also ascertain the deductibility of the expenses in the various countries to determine the optimum timing of those expenses.

#### Conclusion

Foreign professional team athletes need to understand the general features of U.S. tax

law, the taxation of foreign nationals, and tax planning considerations before they decide to immigrate to the United States. Given the substantial salaries earned by professional athletes, savvy tax planning can save the professional athlete taxpayer

tens of thousands of dollars through the minimization of income taxes. Additionally, the Internal Revenue Service has proven, in a very public manner, its intent to enforce compliance with U.S. tax laws by foreign professional athletes. Foreign

professional team athletes should consult qualified, trustworthy U.S. tax professionals who have vast experience dealing with the intricacies and opportunities faced by incoming professional team athletes.

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