

TENNESSEE'S FAILED ATTEMPT TO BE A TAX TITAN

By Jason Feingertz and Jonathan Nehring

IN BRIEF

State legislatures and tax departments sometimes find out-of-state professional athletes who play games in their states an irresistible source of taxable income. Tennessee, however, bit off more than it could chew when it imposed a uniquely onerous “jock tax” on out-of-state athletes from 2009 to 2014. The authors tell the story of the rise and fall of Tennessee’s jock tax, as well as a discussion of the many constitutional issues the tax posed while it was in effect.

In July 2016, the state of Tennessee settled tax disputes with the National Basketball Players Association (NBPA) and National Hockey League Players' Association (NHLPA) on behalf of their respective players. The underlying issue for these disputes was over Tennessee's privilege tax on professional athletes playing games in the state (popularly known as the jock tax), which the state repealed in 2014. This article discusses the developments leading up to the repeal of the Tennessee jock tax, including the settlements with the NBPA and NHLPA, how Tennessee's jock tax

differed from other states' taxes on professional athletes, and the legal challenges it faced.

History of Tennessee's Jock Tax

Although Tennessee does not tax wage income, in July 2009 it began assessing a privilege tax on professional athletes playing at professional athletic events in Tennessee. While Tennessee is host to professional athletic events for the National Association for Stock Car Auto Racing (NASCAR), National Basketball Association (NBA), National Football League (NFL), and National

Hockey League (NHL), only NBA and NHL athletes were subject to this Tennessee privilege tax.

NBA or NHL athletes—as long as they were employed by a team for more than 10 days, were present in Tennessee, and eligible to participate in a game played in Tennessee—were subject to Tennessee's jock tax [Tenn. Code Ann. section 67-4-1702(a)(7)]. This privilege tax was assessed at a flat rate of \$2,500 per game, up to a \$7,500 maximum per year [section 67-4-1703(d)].

Revenue from jock taxes imposed by most other states typically goes into the

states' general fund; however, Tennessee's jock tax revenue was used "exclusively for the payment of, or the reimbursement of, as directed by the facility manager, expenses associated with securing current, expanded or new events for indoor sports facilities located in Tennessee" [section 67-4-1703(e)]. Although the Bridgestone Arena (home of the NHL's Nashville Predators) and the FedEx Forum (home of the NBA's Memphis Grizzlies) are owned by the public, the facility managers of these arenas are the private owners of the Grizzlies and Predators, who were therefore able to direct the use of the tax revenue. Thus, the athletes were effectively taxed by the state to fund the expenses of the team owners for putting on events at publicly owned stadiums.

Background Behind Repeal and Settlement

The beginning of the end for Tennessee's jock tax came during NHL collective bargaining negotiations. In 2013, the NHLPA negotiated a provision into the 2013 Collective Bargaining Agreement (CBA) that required the NHL to pay Tennessee's jock tax on behalf of all of the players. This portion of the CBA effectively resulted in a cash transfer from the other 29 NHL clubs to the Predators because the tax revenue was spent at the discretion of the owner.

In addition, several NBA players, with the guidance of the NBPA, filed refund claims with the Tennessee Department of Revenue in December 2013. These refund claims were for the privilege taxes assessed against the players for the 2009/10 regular season.

Responding to the growing pressure of the NBPA and NHLPA, the Tennessee legislature passed legislation in 2014 that repealed Tennessee's jock tax. Tennessee Representative David Alexander, lead sponsor of the repeal legislation (2014 HB 1134), provided the following statement regarding the need for this repeal:

[This repeal] ends the inappropriate use of the state taxing authority ... the bill [passed in 2009] was constitutionally suspect from the very beginning ... because ... it affected just two particular kinds of professional sports and not all professional sports. In addition to that, the tax itself was not fairly related to the services provided by the state. (Debate on HB1134, House Floor Session Apr. 7, 2014.)

This legislation immediately repealed the tax against NHL players, but delayed repeal for NBA players until after the 2015/16 season. As of June 1, 2016, NBA players no longer have to pay Tennessee's \$2,500-per-game privilege tax. Instead of waiting for this legislated end date, NBA player Marcus Thornton, followed by several others, filed suit in December 2014 with the continued guidance of the NBPA. Before the judiciary could decide the merits of the lawsuits, however, both the NHLPA and NBPA settled their respective players' refund claims with the Tennessee Department of Revenue.

In total, Tennessee collected about \$18.8 million from the professional privilege tax on NHL and NBA athletes from 2010 through 2015 (Andrew Ballard, "Game Over for Tennessee's 'Jock Tax' on NBA Players," *Bloomberg BNA*, June 3, 2016, <http://bit.ly/2fPGHdJ>). In June 2015, the NHLPA settled for a refund of \$3.27M of the \$6.6M in jock tax they paid to Tennessee during 2009–2012 (Liz Mullen, "NHL Players Reach Settlement with State of Tennessee about Jock Tax," *Sports Business Daily*, June 30, 2015, <http://bit.ly/2gvK9Jj>). Nearly a month later, the NBPA and the state settled for a refund of \$5.3M of jock tax paid since 2009 (<http://bit.ly/2ghJbx1>). The final refund payments were made by Tennessee in June 2016.

Tennessee's Jock Tax Compared to Other States'

Compared to the tax regimes in the 26 other states that host at least one team from

one of the four major professional sports leagues, Tennessee's jock tax was unique. Typically, a state imposes its general individual income tax on the income of professional athletes earned within the state. In many states, however, there is heightened enforcement of nonresident income taxation on professional athletes who have earned income within the state. These heightened enforcement schemes are also often referred to as jock taxes.

States typically deem an athlete to have earned wage income in the state when it can be apportioned to the state. Income is generally apportioned among the states based upon the percentage of total "duty days" an athlete spends within a state, typically defined as any day an athlete does some form of work for their employer, such as a media appearance, team practice, or game. Then the apportioned income is multiplied by the state's individual income tax rates.

These general methods of taxing the income of nonresident professional athletes differ greatly from how Tennessee's jock tax was assessed. Tennessee's unique regime gave little consideration to the actual taxpayers. For example, beyond creating unique rules that led to an additional compliance burden, Tennessee created a tax due date extremely burdensome to the entire population of subject taxpayers. Instead of following the typical tax year, Tennessee's tax year for its jock tax was June 1 through May 31, with the tax returns and tax payments due on June 1. Because both the NBA and NHL playoffs continue beyond June 1, if a Tennessee team were to make a deep playoff run, the opposing athletes would be required to prepare file a unique tax return at a crucial moment. In addition, the \$7,500 reset on June 1, hypothetically allowing the state to tax athletes up to \$15,000 during the span of one NHL or NBA season.

Legal Analysis

Not only did Tennessee's jock tax differ from how many other states taxed

professional athletes, it seemingly expanded beyond judicial interpretations of the U.S. Constitution. Under Article 1, section 8, clause 3, also known as the Commerce Clause, Congress is given the power to “regulate commerce ... among the several states.” The converse of this power, commonly referred to as the Dormant Commerce Clause, has been interpreted by the U.S. Supreme Court as disallowing any state from passing legislation that discriminates against “commerce ... among the several states” [see generally *Reading R.R. Co. v. Pennsylvania*, 82 U.S. 232 (1873); *Cooley v. Bd. of Wardens*, 53 U.S. 299 (1851); *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829); *Gibbons v. Ogden*, 22 U.S. 1 (1824)]. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), the Supreme Court set out a framework for analyzing whether state tax legislation violates the dormant commerce clause. Under this framework, a state’s tax is likely unconstitutional if it 1) is applied to an activity that lacks substantial nexus with the taxing state, 2) is not fairly apportioned to activities carried on by the taxpayer in the state, 3) discriminates against interstate commerce, or (4) is not fairly related to the services provided by the state.

Substantial nexus. While establishment of a substantial nexus between a taxpayer and a state has been the subject of much litigation [see *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978); *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954)], it is likely that an NBA or NHL player’s physical presence in Tennessee provided the state with sufficient nexus to impose its jock tax.

Fair apportionment. A taxpayer may have substantial nexus with a state, but that state still must determine in a fair manner what portion of the taxpayer’s

income is to be taxed by the state. The U.S. Supreme Court has established two components that are necessary to equate fairness in apportionment.

The first ... component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the [taxpayer]’s income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. [*Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).]

Simply put, the internal consistency test asks, “If every state were to adopt Tennessee’s version of its jock tax, would interstate commerce be at a disadvantage compared to intrastate commerce?” The external consistency test asks, “Does the method Tennessee uses to apportion income reflect how that income was earned?”

Tennessee’s jock tax likely ran afoul of the internal consistency test. The tax was a flat privilege tax that was not apportioned to reflect any factor other than the amount of times an athlete entered Tennessee to play a game. If every state were to adopt a flat tax for the privilege of playing professional hockey or basketball in their state, athletes would be incentivized to play in as few jurisdictions as possible. State laws that deter interstate commerce in favor of intrastate commerce are exactly what the dormant commerce clause was intended to invalidate.

The \$7,500 per player per year cap on the jock tax also posed internal consistency problems. If an NBA player played all 82 of his regular season games in Tennessee, he would owe no more than \$7,500 under Tennessee’s jock tax. If, however, he instead played his 82 games

in various jurisdictions that had each adopted Tennessee’s jock tax scheme, that same athlete could owe up to \$205,000 in state taxes. The fact that such a player would owe significantly more in taxes than the player who restricted his play to within the state demonstrates that Tennessee’s jock tax acted as a deterrent to interstate commerce.

Tennessee’s jock tax would likely not fare much better under the external consistency test. Although neither the Supreme Court nor any Tennessee courts have issued guidance on what would constitute a reasonable apportionment formula for the income of professional athletes, other courts have. In 2015, the Ohio Supreme Court ruled that Cleveland’s method for apportioning the income of professional athletes was unconstitutional [*Hillenmeyer v. Cleveland Bd. of Rev.*, 144 Ohio St.3d 165 (2015)]. According to the court, Cleveland’s apportionment method, which apportioned income based on the percentage of total games played in Cleveland, did not “reasonably associate the amount of compensation taxed with work the taxpayer performed within the city.” The court also said that Cleveland should utilize the duty-days method. As mentioned above, the duty days method apportions a professional athlete’s income based on each day that athlete performs some official duty for the team that employs him, which includes offseason training camps and workouts. The Ohio Supreme Court also held that Cleveland could not tax an NFL player for a game his team played in the city while he was absent because of injury, ruling that it amounted to extraterritorial taxation [*Saturday v. Cleveland Bd. of Rev.*, 142 Ohio St.3d 528 (2015)].

Assuming his team does not make the playoffs, an NBA player participates in approximately 195 duty days, and an NHL player participates in 215 duty days [Jonathan Nehring, “Pro Athletes Shut Out Cleveland ‘Jock Tax’ at Home,” *State Tax Notes*, June 1, 2015, <http://bit.ly/2gJoCKO>].

Under this analysis, a minimum-salary NBA player would earn \$2,429 per duty day, and a minimum-salary NHL player would earn \$2,419 per duty day. (This calculation uses the average minimum salary for the NBA and NHL from 2009 to 2014, the years Tennessee's jock tax was in effect.) With NBA and NHL teams not typically staying longer than one day at an away team's location, Tennessee's flat tax of \$2,500 per game played in the state would represent an effective tax rate of more than 100% for some players. As a consequence, even if Tennessee courts were to deem the duty days apportionment method reasonable, they would still likely determine that taxing more than 100% of a professional athlete's income earned in Tennessee would fail the external consistency test.

Even if the judiciary wished to leave the definition of a reasonable apportionment method to the legislature, Tennessee's jock tax would still likely fail the external consistency test. *Container Corp.* requires the "factor or factors used in the apportionment formula [to] actually reflect a reasonable sense of how income is generated." It is unlikely that a court would find a flat fee on travel into Tennessee to reflect a reasonable sense of how professional athletes generate income.

Discrimination against Interstate Commerce. Under the *Complete Auto* test, a tax cannot in effect discriminate against interstate commerce in favor of intrastate commerce. As the Supreme Court detailed in *Am. Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 275–87 (1987), this third prong of the *Complete Auto* test varies from the "internal consistency" portion of the test. The internal consistency test analyzes how interstate commerce is treated under a hypothetical fact pattern where every state adopts that same tax scheme; however, the third prong of the *Complete Auto* test avoids looking at "the formal language of the tax statute but rather [examines] its prac-

tical effect" to determine if interstate commerce is treated discriminatorily.

Because Tennessee's jock tax was a flat tax and limited to \$7,500 per player, professional athletes visiting the state for only a few games would owe much more tax to Tennessee on a per game basis than one playing a full slate of home games. The amount of tax due per game for a professional athlete visiting Tennessee for one game would be \$2,500; in contrast, a Tennessee athlete's tax due per game, assuming 40 games played in Tennessee and the maximum jock tax limit of \$7,500, would be a mere \$188. This shows a likely discriminatory effect to interstate commerce. As opined in *Am. Trucking*, the "imposition of . . . flat taxes for a privilege that is several times more valuable to a local [taxpayer] than to its out-of-state competitors is unquestionably discriminatory and thus offends the Commerce Clause."

Fair relation to services provided by Tennessee. The final prong of the *Complete Auto* test requires Tennessee's jock tax to be fairly related to the services provided by Tennessee. While this prong generally gets little attention in the typical dormant Commerce Clause analysis, litigation over this Tennessee jock tax could have presented a fact pattern instigating analysis on this less heralded portion of the *Complete Auto* test.

This analysis does not exhaust all of the potential legal and constitutional challenges that could have been raised against Tennessee's jock tax. The complaint brought by the class of NBA players alleged that Tennessee's jock tax also violated the U.S. Constitution's Equal Protection Clause, as well as various portions of Tennessee's constitution. The fact that Tennessee's jock tax did not tax the income of professional athletes participating in other sporting events within Tennessee, such as the wages of NFL players, allows a case to be made that Tennessee's jock tax did not even satisfy the rational basis necessary to withstand

an Equal Protection Clause challenge. The NBPA complaint also alleged that professional athletes did not fall within any of the categories of professions upon which the legislature was authorized to levy a privilege tax under the Tennessee constitution.

Beyond the Foul Line

Because Tennessee settled with the NBPA and the NHLPA, whether Tennessee's jock tax violated the U.S. Constitution's Commerce Clause will never be resolved. The recent actions of Tennessee's legislative and executive branches, however, imply a lack of faith that the jock tax could have withstood legal scrutiny.

States should think twice before imposing discriminatory taxes. While the high revenue, publicized schedules, and inability to vote will always make non-resident professional athletes an easy target, the demise of Tennessee's jock tax indicates that athletes with proper professional advice can successfully defend their constitutional rights. □

Jason Feingertz, JD, CPA, is a state tax associate at Reed Smith LLP, New York, N.Y., with experience representing sports franchises and players. Jonathan Nehring, JD, is a tax attorney at Macquarie Group, New York, N.Y., and maintains a blog on tax issues within the sports and entertainment industry at www.taxaball.com.