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### Massachusetts Tax Planning for Professional Athletes: Taking Advantage of the Special Treatment Afforded for Signing Bonuses

#### Tax Policy

Massachusetts has a relatively high income tax rate, making contracts for nonresident professional athletes signed there less lucrative than contracts signed for teams in other states. In this article, Reed Smith's Michael Jacobs and Jason Feingertz discuss how nonresident athletes can use signing bonuses to reduce their state income tax burden when signing with a Massachusetts team.



By Michael Jacobs and Jason Feingertz

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Tom Brady's "Deflategate" suspension and the resulting litigation have provided sports fans across the country with a quick lesson on the laws surrounding collective bargaining agreements. However, those who paid careful attention to the details of the case may have also learned an important lesson about the benefit of tax planning for professional athletes. Specifically, Brady's choice to have a substantial portion of his 2016 compensation paid in the form of a signing bonus not only helped to protect Brady from a loss of income during any suspension imposed by the NFL, but this choice may also have helped reduce the amount of Brady's income subject to Massachusetts personal income tax.

The laws governing the state taxation of signing bonuses paid to professional athletes can create an opportunity for teams based in high-tax states to recruit star athletes while helping those athletes to minimize their state income tax burden. For these reasons, it is important that both teams and athletes (and their representatives) understand the concepts that govern state tax residency for individuals, and how different contractual payment terms will impact the state taxation of nonresident athletes.

Massachusetts imposes a 5.1 percent income tax on all of the income of Massachusetts resident individuals, as well as on the Massachusetts-source income of nonresident individuals, including professional athletes.<sup>1</sup> Massachusetts' relatively high personal income tax rate can make signing a contract with a Massachusetts team less lucrative for a professional athlete who is not a Massachusetts resident than signing an otherwise similar contract with a team in a jurisdiction with a lower state personal income tax rate. However, if a nonresident athlete elects to receive a portion of his compensation in the form of a signing bonus rather than as salary, and the bonus satisfies three requirements set forth in Massachusetts' tax regulations, then the bonus will not be treated as Massachusetts-source income.

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<sup>1</sup> G.L. ch. 62, §§4, 5A.

The regulatory exception for signing bonuses creates a significant tax savings opportunity for a nonresident athlete signing a contract with a Massachusetts team. In this article, we will compare the contracts recently signed by Tom Brady of the New England Patriots and David Price of the Boston Red Sox to demonstrate how nonresident athletes can take advantage of the exception for signing bonuses to reduce their state income tax burden when signing with a Massachusetts team.

#### Massachusetts Residency: An Overview

Residents of Massachusetts are taxed on all of their taxable income, whether derived from Massachusetts sources or elsewhere.<sup>2</sup> As a consequence, a professional athlete who is a Massachusetts resident will be subject to Massachusetts personal income tax on all of his compensation, regardless of whether it is classified as a signing bonus. Thus, the Massachusetts tax saving opportunities discussed in the remainder of this article are addressed toward professional athletes who are not Massachusetts residents.

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<sup>2</sup> G.L. ch. 62, §4. A Massachusetts resident individual can, however, claim a credit for income tax paid to other states on income taxed by Massachusetts, in order to avoid double taxation. G.L. ch. 62, §6(a).

However, before proceeding further, a brief primer on the tests applied to distinguish between individuals treated as Massachusetts residents and those treated as nonresidents is in order. In simple terms, an individual is treated as a Massachusetts resident for income tax purposes either if they are "domiciled" in the commonwealth or if they satisfy a statutory residency test.<sup>3</sup>

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<sup>3</sup> G.L. ch. 62, §1(f).

Under Massachusetts law, an individual's domicile is generally defined as their permanent home—where they intend to reside for the indefinite future.<sup>4</sup> An individual can reside in multiple states, but they can have only one domicile. Typically, the Massachusetts Department of Revenue will examine various objective factors related to a person's major life interests, including family relations, business connections, social activities, and health care, in determining whether an individual possesses the intent to be domiciled in Massachusetts.<sup>5</sup>

<sup>4</sup> 830 CMR 62.5A.1(2).

<sup>5</sup> Massachusetts Technical Information Release No. 12-10 (2012).

Once an individual is domiciled in Massachusetts, that domicile is deemed to continue until the individual establishes a new domicile by demonstrating intent to make their permanent home in a new location.<sup>6</sup>

<sup>6</sup> See e.g., *Commonwealth v. Davis*, 284 Mass. 41 (1933) at 49-50 (“[Domicile] is said to be the place of actual residence with intention to remain permanently or for an indefinite time...Domicil[e] of origin is not lost until a new domicil[e] is actually acquired.”).

Even if an individual is not domiciled in Massachusetts, they can still be treated as a Massachusetts resident for income tax purposes if they satisfy certain statutory tests. Thus, under Massachusetts law, an individual who maintains a permanent place of abode in Massachusetts and, in the aggregate, spends more than 183 days of the taxable year in Massachusetts is classified as a resident.<sup>7</sup> A “permanent place of abode” is defined as a dwelling place that is continually maintained by the individual, whether or not owned by the individual, including a dwelling owned or leased by the person’s spouse.<sup>8</sup> Additionally, any part of a day spent within the commonwealth, regardless of the reason, is counted as a day spent in Massachusetts.<sup>9</sup>

<sup>7</sup> G.L. ch. 62, §1(f).

<sup>8</sup> Massachusetts Technical Information Release No. 95-7 (Jan. 10, 1996).

<sup>9</sup> G.L. ch. 62, §1(f).

Massachusetts statutory residency provisions can be tricky to understand and apply. But for a professional athlete who is not domiciled in Massachusetts, the key point to keep in mind is that if the athlete has access to a permanent place of abode in Massachusetts, then they must keep close track of the number of days in which they are present in Massachusetts in each year, regardless of whether they are present in Massachusetts for business or pleasure.

Professional athletes who claim to be nonresidents of Massachusetts should be prepared for an audit of their residency status. These audits are frequently intrusive, resulting in inquiries regarding the taxpayer’s business and family ties to Massachusetts, the amount and nature of the time spent by the taxpayer in Massachusetts, and the presence of the taxpayer’s personal belongings in Massachusetts. While each audit is unique to the facts and circumstances of the taxpayer, it is important for tax advisors to assemble facts and information both to defend against a potential assessment before the audit concludes, and to optimally position an individual’s case in the event of an appeal or litigation of a tax assessment.

#### Massachusetts’ “Jock Tax.”

Although all nonresident individuals are subject to Massachusetts income tax on their Massachusetts source income, nonresident athletes are subject to special rules for determining Massachusetts-source income. These special sourcing rules, like similar rules imposed in other states, are often referred to as a “jock tax.” Under its “jock tax” rules, set forth at 830 CMR 62.5A.2, Massachusetts apportions the base salary of members of professional athletic teams to the commonwealth based upon the percentage of total “duty days” the athlete spends within the commonwealth rendering services for his or her team during the taxable year.<sup>10</sup> This apportioned income is then subject to the commonwealth’s regular income tax rates.

<sup>10</sup> 830 CMR 62.5A.2(2).

For purposes of the Massachusetts “jock tax” rules, every day spent in the commonwealth does not count as a “duty day.” Under the rules, a duty day is defined as any day in which an athlete does some form of work for their team such as a game, team practice, or media appearance.<sup>11</sup> However, a day for which an athlete is not compensated and is not rendering services for the team in any manner, including a day spent suspended without pay, is not treated as a duty day.<sup>12</sup>

<sup>11</sup> 830 CMR 62.5A.2(3)(“Duty Days”).

<sup>12</sup> *Id.*

Remuneration paid to a professional athlete for signing a contract is not apportioned to the commonwealth under the “jock tax” rules if all of the following conditions are met: (a) the payment for the signing bonus is not conditional upon the signee playing any games for the team; (b) the signing bonus is payable separately from the salary and any other compensation; and (c) the signing bonus is nonrefundable.<sup>13</sup> Thus, if a professional athlete is not a Massachusetts resident, a payment that satisfies these three conditions can escape Massachusetts income taxation.

<sup>13</sup> 830 CMR 62.5A.2(3)(“Bonuses”).

#### Tom Brady’s Situation.

On April 25, 2016, the U.S. Court of Appeals for the Second Circuit ruled in favor of the NFL, overturning a lower judge’s decision to vacate Patriots quarterback Tom Brady’s four-game Deflategate suspension.<sup>14</sup> Under the Second Circuit ruling, Brady will miss the first four games of the 2016 season. On May 23, 2016, Brady filed an en banc appeal to the Second Circuit, asking the court to review its decision. Despite Brady’s exhaustive attempts to fight the suspension, he has at the same time prepared well for the financial impact of the suspension should it ultimately be enforced.

<sup>14</sup> *Nat’l Football League Mgmt. Council v. Nat’l Football League Players Assoc.*, Nos. 15–2801 (L), 15–2805(CON), 2016 WL 1619883 (2d Cir. Apr. 25, 2016),

Under the NFL’s Collective Bargaining Agreement, a player loses 1/17 of his annual salary for each game they are suspended.<sup>15</sup> However, a signing bonus is not subject to the Collective Bargaining Agreement’s penalty provisions. In anticipation of the suspension being enforced, Brady restructured his contract with the Patriots and converted the \$9 million base salary payment that he was scheduled to receive for the 2016-17 season into an \$8 million signing bonus and a \$1 million base salary. This restructuring not only shielded Brady’s income from the impact of a potential suspension, but it may have also prevented the Commonwealth from taxing the portion of the salary converted into a signing bonus. Assuming that Brady is not a Massachusetts resident, he will not be required to apportion the signing bonus to Massachusetts under the commonwealth’s “jock tax” rules.<sup>16</sup>

<sup>15</sup> National Football League Collective Bargaining Agreement (2011), available at <http://www.nflpa.com/>.

<sup>16</sup> For the purposes of this article, the authors assume that Brady is not a Massachusetts resident for personal income tax purposes. The authors do not possess any detailed knowledge of Brady's personal affairs that would allow them to determine his domicile or whether Brady would satisfy Massachusetts' statutory residency test.

Many in the public may assume that Brady is a resident of Massachusetts, simply because he owns a substantial home in Massachusetts and has been the star quarterback of the New England Patriots for the past 15 years. However, like many high-wealth individuals, Brady owns homes in several states. Therefore, Brady's ownership of a substantial home located in Massachusetts, by itself, does not necessarily mean that he is a Massachusetts "resident" for tax purposes. If Brady is not a resident of Massachusetts, then he would still be subject to Massachusetts income tax on the portion of his base salary apportioned to Massachusetts under its "jock tax" on nonresident athletes.

Assuming that Brady is a nonresident of Massachusetts, Brady will be required to apportion his \$1 million salary to the commonwealth based on his duty days spent in the state. However, if the terms of Brady's contract meet certain conditions, then none of the signing bonus would be allocable to the commonwealth. Specifically, if the payment of the signing bonus is not conditional upon Brady playing any games for the Patriots, the bonus is payable separately from Brady's salary, and the signing bonus should be nonrefundable. If these three requirements are met, then Brady's decision to convert \$8 million of salary to a signing bonus will have reduced his Massachusetts income tax bill by approximately \$340,000 (\$8,000,000 times an assumed duty days ratio of 85 percent and a tax rate of 5.1 percent).

#### David Price: A Comparison

David Price's signing of a \$217 million, seven-year contract with the Boston Red Sox has also recently been in the news. Assuming that Price is not a resident of Massachusetts, his contract would appear to be a lot less advantageous than Brady's, from a tax planning perspective. Price's contract, signed in December 2015, makes Price the highest paid pitcher in Major League Baseball. The contract was reported to pay the entire \$217 million in the form of salaries, spread out over the seven years of the deal.

Price's historic state of domicile is in Tennessee.<sup>17</sup> Tennessee does not have a state personal income tax. As a consequence, from a state tax planning perspective, Price will want to maintain his domicile in Tennessee instead of taking actions that would indicate that he has changed his domicile to Massachusetts. Maintaining a Tennessee domicile should allow Price to avoid being subject to Massachusetts income tax on all of the payments under the new contract. However, even if Price is able to maintain his Tennessee domicile (and he avoids becoming a statutory resident of Massachusetts), he will still need to apportion his salary to Massachusetts based on the number of duty days he spends in the commonwealth during the season.

<sup>17</sup> See Chris Bahr, Red Sox Ace David Price donates \$300K for Miracle Field project in hometown, FoxSports (Feb. 5, 2016), <http://www.foxsports.com/mlb/story/david-price-boston-red-sox-miracle-field-donation-murfreesboro-tennessee-hometown-020516>.

If Price establishes residency in Massachusetts as a member of the Red Sox, he will owe the commonwealth over \$11 million in income tax on the payments under his Red Sox contract over the next seven years. In contrast, if Price does not qualify as a resident of Massachusetts, he will still owe over \$4 million in income tax to the commonwealth over the life of the contract, based on his expected "duty days" in Massachusetts.

While negotiating the contract, Price would have been well advised to consider structuring a portion of the payments under the contract as a signing bonus. Assuming that Price is not a Massachusetts resident, structuring the contract in this matter would have had a significant effect on his Massachusetts income tax liability. For example, if Price had structured the Red Sox contract so that the first year of payments under the contract qualified as a signing bonus, while maintaining his Tennessee domicile, Price would not have been subject to Massachusetts income tax on the bonus.

#### Conclusion

While negotiating the terms of their next playing contract, it is imperative that professional athletes utilize the advice of their tax advisor to determine the best way to structure the compensation included in a playing contract. For a professional athlete signing with a team located in Massachusetts, signing bonuses present a unique opportunity to minimize their Massachusetts tax liability. While most players will not have the negotiation leverage of a Tom Brady or a David Price, they should still explore this opportunity while discussing the terms of the contract. Similarly, the Red Sox, Patriots, Celtics and Bruins should offer free agents who are not Massachusetts residents a compensation package that includes a qualifying signing bonus in order to make their package more competitive with otherwise similar packages offered by teams located in states with a lower personal income tax rate. This would allow them to increase the after-tax salary they offer to any nonresident free agents, without risking an increase to their payroll.