Winning tax strategies and planning for athletes and entertainers: Participants's manual;

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WINNING TAX STRATEGIES
AND PLANNING FOR
ATHLETES AND
ENTERTAINERS

By
BARRY KLARBERG, CPA
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WINNING TAX STRATEGIES AND PLANNING FOR ATHLETES AND ENTERTAINERS

FOREWORD

The escalation of professional athletes' and entertainers' compensation has been nothing short of phenomenal. With that escalation comes unique tax and financial planning problems and opportunities. And, special problems apply to athletes/entertainers. Many perform in numerous states and even foreign countries. Athlete/entertainer clients therefore need specialized planning and tax advice.

That is why the AICPA is the leader in offering a course that deals with these unique tax issues. Your clients will benefit from the practical ideas and insights in this course, while the CPA will be able to expand his or her practice in this most lucrative field.

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ACKNOWLEDGMENTS

We wish to recognize the following Professional Development and Production Services staff for their contribution to the development and production of the current edition of this course.

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WINNING TAX STRATEGIES AND PLANNING FOR ATHLETES AND ENTERTAINERS

IMPORTANT NOTICE

- This manual can be used in several ways.

  It can be presented as a Group Study course off-site as a seminar or on-site for in-firm training.

  It can also be used as a Self-Study course. ALL Self-Study participants must complete the exam.

  - The exam for Self-Study participants is in the Examination Packet.

  - The Course Code Number for the Self-Study Exam is on the cover of the Examination Packet.

- The section titled Administrative Matters for Self-Study Participants begins on page 7.

- The section titled Administrative Matters for Group Study Participants begins on page 8.
WINNING TAX STRATEGIES AND PLANNING FOR ATHLETES AND ENTERTAINERS

ADMINISTRATIVE MATTERS FOR SELF-STUDY PARTICIPANTS
(Administrative Matters for Group Study Participants are on page 8)

CPE Credit

To earn a self-study Certificate of Completion for Recommended Continuing Education Credit for this course, YOU MUST COMPLETE THE EXAMINATION in the Examination Packet.

- If you receive a grade of 75% or better on the examination, we will send you a certificate recommending the appropriate number of CPE credits.

Course Evaluation Form

Please fill out the course evaluation form which is included in the package of your course materials. You may mail it along with your examination answer sheet in the envelope provided. Your comments are important to us for preparing new courses and future editions of this course.

News Release

A sample news release for local media can be found on the last page of the manual. This is intended to attract attention to you and your organization concerning the furtherance of your professional education.

Responsibility for Keeping CPE Records

The widely adopted Statement on Standards for Continuing Professional Education (CPE) Programs places responsibility on both the individual participant and the course sponsor to maintain a record of satisfactory completion for CPE self-study courses. Therefore, you should keep the following information on each course:

- The sponsor-provided Certificate of Completion.

- Other information you feel would be helpful in reporting your CPE credits to your state board (e.g., the manual and notes you may have taken).

This information on CPE credits should be included in one or both of the above.

The information should be kept for an appropriate period of time to enable regular periodic reporting to jurisdictional boards of accountancy and to professional organizations requiring such reports. Some state boards request copies of this information directly from registrants. Others will contact the program sponsor to confirm those details provided by CPE participants on a registration form. Sponsors are required to keep documentation on programs for five years.

Suggested Solutions

All problems, exercises, activities, etc., have at least one suggested solution, even if there may be more than one way to solve a problem. There are no official answers, nor is there one right way to arrive at a solution. In most cases, the suggested solutions to problems, exercises, and activities follow all the problems, exercises, or activities in a particular chapter.
ADMINISTRATIVE MATTERS FOR GROUP STUDY PARTICIPANTS

Name Card

To lend a more personal atmosphere to the group discussion, a name card is provided for your use. At the beginning of the seminar, place the card directly in front of you so that it can be read by the discussion leader and as many of the other participants as possible.

Evaluation Form

The information we accumulate from Participant Evaluation Forms is an important element in our continual efforts to provide high quality continuing education for the profession. A machine-readable form will be distributed to you during the program. Please follow the instructions on the form. It is especially important that you use either a No. 2 black lead pencil or a blue or black ball point pen.

News Release

A sample news release for local media can be found on the last page of the manual. This is intended to attract attention to you and your organization concerning the furtherance of your professional education.

Responsibility for Retention of Records on CPE Credit

Participants, as well as program sponsors, must maintain a record of attendance at a CPE program. The Statement on Standards for Continuing Professional Education (CPE) Programs places responsibility on the individual participant to keep the following information on each program:

- Sponsor’s name (state society for public presentations; firm or company for in-house presentations)
- Title and description of course content
- Date(s) of program
- Location of program
- Number of credits

This information can be found in the promotional material for most courses. These documents should be kept for an appropriate period to enable regular periodic reporting to jurisdictional board(s) of accountancy and to professional organizations requiring such reports.

Some state boards require copies of this information directly from registrants; others will confirm with the program sponsor those details provided by CPE participants on the registration forms. Sponsors are required to keep documentation on programs for five years.

Suggested Solutions

All problems, exercises, activities, etc., have at least one suggested solution, even if there may be more than one way to solve a problem. There are no official answers, nor is there one right way to arrive at a solution. In most cases, the suggested solutions to problems, exercises, and activities follow all the problems, exercises, or activities in a particular chapter.
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WINNING TAX STRATEGIES AND PLANNING FOR ATHLETES AND ENTERTAINERS

OVERVIEW

INTRODUCTION

This course tackles the unique tax issues in the sports and entertainment industry. It's a seminar that covers all the bases from basic concepts to tax and financial planning opportunities.

ORGANIZATION

The course was designed to be conducted as follows:

- The Discussion Leader will provide an overview of the material in each chapter.
- Then, participants will be encouraged to ask questions and interact with each other.
- Finally, each chapter concludes with discussion questions designed to meet the chapter's objectives.

COURSE GOALS

Upon completion of this course, you will be able to:

- Advise clients in the sports and entertainment industry on unique tax planning considerations.

CONCLUSION

We hope your reading of the manual, after attending the seminar, will further enrich the professional learning experience gained from your participation.

Note: We use the terms he and she alternately throughout the course (except when a particular person is mentioned) since both sexes are well represented in the tax area.
WINNING TAX STRATEGIES AND PLANNING FOR ATHLETES AND ENTERTAINERS

1998 TAX CHANGES

TAX LEGISLATION UPDATE

Roth IRA’s

1998 ushers in a new form of IRA, called the Roth IRA after its Senate sponsor. The Roth IRA is sometimes called a “backloaded” IRA, because the tax benefits come when you’re taking money out, rather than putting it in.

Unlike a traditional IRA, you cannot take a deduction for contributions that you make to a Roth IRA. However, as long as you are at least age 59 ½ and a five-year period has passed since your first contribution, money that you take out from the Roth IRA will be tax-free. That includes interest, dividends, and other amounts earned on your contributions while they were in the Roth IRA.

Your Roth IRA contribution will be limited if your adjusted gross income exceeds $150,000 ($95,000 for single taxpayers). The maximum amount that you can contribute each year to all of your IRAs together, including traditional IRAs and Roth IRAs, is still $2,000. You can contribute to Roth IRAs even if you’re older than 70 ½.

If your adjusted income is less than $100,000, and you are not married filing separately, you can roll over money from a traditional IRA to a Roth IRA, but you will probably have to pay some tax if you do that. You can spread the tax over four years if you make the rollover during 1998.

Child Tax Credit

The child tax credit is a new credit that can take $400 off your tax bill for each child you support. To qualify, your child must be under 17 at year-end and a U.S. citizen or resident. The credit will rise to $500 per child in 1999.

Like many other tax credits so many goodies in the tax law, this one is reduced, then eliminated, as your income climbs. The phaseout starts at $110,000 for joint filers ($75,000 if unmarried, $55,000 if married filing separately). At and above that level, each $8,000 ($10,000, after 1998) in additional income wipes out one child credit. The income level at which the credit is completely eliminated depends on the number of children in your family.
For some low-income families with three or more qualifying children, the child credit becomes a refundable credit.

EDUCATION TAX BREAKS

There are a number of new ways the tax laws can help you finance higher education expenses.

If your income is below $100,000 ($50,000 if single) and you pay college, graduate school or vocation school tuition for yourself, your spouse or your dependant, you may qualify for one of two new tax credits:

- The Hope Scholarship Credit, a tax credit of up to $1,500 per student per year for the first two years of the student’s post-secondary education.
- Lifetime Learning Credit, a tax credit equal to 20% of the post-secondary tuition paid each year. The maximum credit per tax return is $1,000 per year. Tuition for continuing education qualifies for the credit, as long as the student is acquiring or improving his or her job skills.

These credits are not available if you are married filing separate returns.

Another option, if your income is below $160,000 ($110,000 if single), is to open an Education IRA. You can contribute up to $500 per year per child to the IRA. Your contributions will grow, tax-free, in the education IRA, just as they would in a traditional or Roth IRA. Then, you can withdraw funds from the IRA for your child’s higher education expenses without owing any tax or penalty.

For low-to-middle income taxpayers, an additional tax benefit will be the revival of the interest deduction for student loans. The income cut-off is $75,000 ($55,000 if single). The deduction will be available even if you do not itemize, but is limited to $1,000 in 1998. The dollar limit will rise by $500 per year until it reaches $2,500.

One caveat with all these tax incentives: they are intended to complement each other. For example, you can not take both the Hope Scholarship Credit and the Lifetime Learning Credit in one year for the same child’s tuition. You can not take an itemized deduction for interest you paid on a home equity loan, then turn around and deduct the interest as education loan interest.

CAPITAL GAINS TAX REFORMED

The 1998 capital gains tax rules break capital gains and losses down into four categories:

- Short-term gain and loss (sales of assets held one year or less). Net short-term capital gain is taxed at ordinary income tax rates.
OVERVIEW

• “28%” gain and loss (sale of stamps, coins, rugs, antiques, gems and other collectibles, and eligible gain on qualified small business stock). Net 28% gain is taxed at the rate of 28% (15%, if you are in the 15% bracket).
• Unrecaptured §1250 gain. If you sell real estate that you depreciated, your gain will be taxed 25%, up to the amount of depreciation you took that was not taxed at ordinary income rates under the recapture rules.
• Other long-term gain and loss (sales of assets held more than one year) is taxed at a maximum rate of 20% (10% if you are in the 15% bracket).

HEALTH INSURANCE DEDUCTION FOR SELF-EMPLOYED

This deduction has increased to 45% of qualifying expenses for 1998.

The deduction will increase to 60% of qualifying expenses in 1999, 2000 and 2001, 70% for 2002 returns and 100% thereafter.

To take advantage of the deduction, your business must turn a profit, and in the month the premium is incurred, neither you nor your spouse (if you have one) can be eligible for an employer’s health plan.

MORE GENEROUS SECTION 179 WRITE-OFF

You can now elect to write off up to $18,500 when you buy equipment to use in your business. This limit will increase gradually to $25,000 in 2003.

OTHER IRA CHANGES

Several changes in the IRA rules may make it easier for you to make deductible IRA contributions, or tap your IRA funds, beginning in 1998:

• If you participate in your employer’s retirement plan, your IRA contribution is not deductible if your income exceeds a certain limit. For 1998, the limit has been increased, to $60,000 if you’re married filing jointly, and to $40,000 if you’re single. This income limit will continue to increase gradually, until it reaches $60,000 in year 2005 (if you are single) and $100,000 in year 2007 (if you are filing a joint return).
• Prior to 1998, the income limits for deductible IRA contributions were the same if you or your spouse was an active participant in an employer plan. Beginning in 1998, you can take advantage of a special limit of $160,000 if your spouse is covered by a retirement plan at work but you are not.
• Beginning in 1998, you can make IRA withdrawals before age 59 ½ without paying the usual 10% penalty if you use the funds to pay college or graduate school expenses for yourself, your spouse or you children or grandchildren.
• Beginning in 1998, the 10% early withdrawal penalty also will not apply to the withdrawal of up to $10,000 for the purchase of a first home by yourself, your spouse, or your children, grandchildren, parents, or grandparents.

ESTIMATED TAX PENALTIES SAFE HARBOR

To meet budget goals, Congress tinkered with the safe harbor rules for estimated tax payments. The safe harbor is the amount of last year’s taxes you must pay as estimated taxes this year to avoid underpayment penalties. For 1998, the safe harbor is 100% of last year’s taxes, no matter what your income level was last year. (For 1997, the safe harbor was 110% if last year’s income was over $150,000.) The safe harbor percentage for higher-income taxpayers is slated to climb slightly over the next several years (105% in 1999).

Beginning in 1998, if your withholding is within $1,000 of the amount of tax you owe for the year you are not subject to an underpayment penalty. Before 1998, that threshold was just $500.

INCREASE IN STANDARD DEDUCTION FOR EMPLOYED DEPENDANTS

Dependants with significant earned income will receive $250 increase in their standard deduction in 1998. The hike in the standard deduction typically will benefit college students who have some investment income in addition to their income from a part-time or summer job.

EASIER TO CLAIM FOREIGN TAX CREDIT

Many people discover when they get a mutual fund statement or K-1 for the year that their mutual fund or partnership paid foreign income taxes on their behalf. Typically, the amounts are fairly small. Beginning with your 1998 tax return, you can bypass Form 1116 and simply take a dollar-for-dollar tax credit if you fit these guidelines:

• The foreign taxes were under $300 ($600 if married filing joint return.)
• The income on which the taxes were paid was entirely investment income, such as interest, dividends or capital gains.

LEASED VEHICLES

People who use a leased vehicle may use the standard mileage method to determine their deductible vehicle expense. Previously, this method was only available to people who own their own vehicle.
EXTENDED TAX BREAKS

Some tax breaks expired during 1998, but legislation restored them retroactively:

- The research tax credit has been extended to June 30, 1999
- The charitable contribution deduction for the fair market value of appreciated stock donated to a private foundation has been made permanent.

USEFUL NUMBERS

Some key numbers for tax deductions change from time to time. Here are the amounts for 1998:

- Mileage rate for Business use of a car: 32.5 cents
- Mileage rate for charitable use of a car: 14 cents
- Mileage rate for use of a car to move, or for medical reasons: 10 cents
- Write-off limit for new equipment ("§179 deduction"): $18,500.
CHAPTER 1

COMPENSATION

OBJECTIVES

- Advise highly compensated clients concerning bonuses and salary.
- Devise a plan to save taxes by deferring income and generating passive income.

INTRODUCTION

Athletes and entertainers are often highly compensated for performing their respective skills. In addition to receiving compensation for services, athletes and entertainers also may derive income from bonuses, prizes, awards, personal appearances, endorsements, and royalties from books and movies. As with any taxpayer, gross income will include all income from whatever source derived unless it is specifically excluded. Athletes are further unique, however, in that unlike the average taxpayer, their peak income producing years occur early in a career and last a relatively short time.

Financial goals should consist of a plan which affords the individual enough resources to live a desired lifestyle during playing or entertaining days, while preserving and investing enough capital to maintain and enhance a standard of living during retirement. For today's athlete or entertainer, with proper planning and some expert tax advice, these goals can be attained.

The following is a discussion of various forms of compensation and planning ideas to minimize tax. Although the primary focus of this chapter is on professionals, there are certain situations that affect the amateurs as well.

BONUSES

Often times, the most highly sought after athletes are those who have not yet reached the age of majority. Although these players have not reached their physical maturity, they have displayed outstanding skills on their high school playing fields and are viewed by professional scouts as having the potential to compete at the top level in their respective sports. As a result of this enormous potential, professional teams are willing to pay bonuses of anywhere from hundreds to over $1.5 million just for an agreement with the player not to negotiate a contract with another team.
CLASSIFICATION FOR TAX PURPOSES

There has been significant controversy surrounding the legal status of the bonus as well as its proper treatment and classification for tax purposes. The bonus cannot be treated as traditional compensation, because under most contracts, if a player is later cut from the team, he is permitted to keep the entire bonus. Conversely, if a player is cut from a team, he is no longer entitled to compensation. In addition, the actual signing of the contract is the impetus for the bonus, whereas compensation is paid for the actual performance of services. For these reasons, it is evident that the signing bonus shouldn’t be treated as compensation.

There have been other situations in which bonuses have been classified as gifts, as a salary advance and as amounts paid for a binding option.

Despite these rulings, the most commonly accepted classification of a bonus is:

- An amount paid to an athlete for signing a contract
  
  It is predicated upon the athlete performing the initial terms of the contract.
  
  - The primary contingency to fulfilling the initial terms of the contract is that the athlete must report for training camp and make a good faith effort to perform to the best of his ability.

The issue then arises as to the taxability of these bonus payments. There are three types of signing bonuses.

Initial Contract

The first type is: A bonus that a professional club pays to an amateur player for signing the initial contract.

The amount constitutes consideration solely for an agreement not to negotiate with other professional teams and/or as consideration to forgo attending college. It is separate and distinct from a bonus which binds a player to perform services (contingent bonus). It is not predicated upon whether the player is retained by the club for any length of time or if he actually performs any services.

Treatment

Considering the fact that these bonuses are not classified as paid for past, present, or future services to be performed, the question arises whether these bonuses should be taxed as wages subject to the withholding of income tax under section 3402 of the Internal Revenue Code, as well as the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).
The Internal Revenue Service has ruled that bonuses paid to new baseball players for signing their first contract that are not predicated on continuing employment do not represent remuneration for services performed and accordingly, do not constitute wages subject to the withholding of income tax under section 3402. This ruling extends to other professional sports where the circumstances are similar.

Additionally, this rule holds even if the bonus payments are to be paid over a number of years (an entry level signing bonus paid to a professional baseball player may be deferred only to the end of the calendar year following the date on which the signing bonus was agreed to).

**Example 1-1:**

- A professional athlete signs for a bonus of $500,000;
  - Half is to be received today, and
  - Half to be received one year from today.

**Result:**

- Neither portion of the bonus will be subject to withholding.

There are situations where a contract is structured so as to include a bonus, part of which is conditioned upon the performance of future services. In such a case, there is an allocation of the portion of the bonus that is predicated upon future services and the part that is not.

**Example 1-2:**

- A player signs a contract which includes:
  - A $25,000 bonus this year, and
  - $25,000 if he makes the team the following year.

**Result:**

- Since the part of the bonus to be paid next year is conditioned on services to be performed, it will therefore be subject to withholding.

**Note:** Bonus payments received under any of the aforementioned circumstances are taxable to such individuals as ordinary income in the tax year they are received.

Since capital gains enjoy preferential treatment, there have been attempts by athletes (or their creative accountants) to classify the bonus payments as capital gain income on the ground that they were
promising themselves, or their services, (a capital asset) to one professional team. However, The IRS takes the position and the courts have concurred that a promise not to work for others is not a conveyance of capital asset property. Therefore, the proceeds received from such a promise constitute ordinary income and not gain from a disposal of a capital asset.

**Status Bonus**

The second type is: One conditioned upon future employment (Status bonus.)

This is common with players who are signing a new contract. It is awarded as additional consideration for signing the new contract and is predicated upon the performance of future services and/or upon the player being retained by the team for a specified time.

If at any time the player fails or refuses to adhere to specified team policies (reporting for camp; quitting without team consent etc.), the player is obligated to return a proportionate amount of the bonus not yet earned.

**Note:**

- Since these bonuses are conditioned upon the occurrence of certain events (i.e., player making the team or remaining with the team for specified period of time, etc.), they are considered as remuneration for past and future services.
- They are subject to withholding, FICA, and FUTA tax under section 3402.

**Incentive Bonus**

The third type is: The statistical performance or incentive bonus.

This is an incentive plan usually drawn into the contract whereby a player receives a particular sum of money for achieving certain specified goals during the season.

Examples of statistical performance bonuses are:

- A quarterback who is guaranteed a $150,000 bonus if he throws at least 25 touchdown passes for the season, or
- A basketball player who is awarded $100,000 if he leads the NBA in scoring.

These incentive bonuses are negotiable and there is virtually no limit to the various statistics that can be used for the plan.
Note:

- These bonuses are all treated as compensation for past or future services.

They are subject to withholding, FUTA, and FICA.

NONRESIDENT ALIENS

In recent years, it has become commonplace for professional teams to recruit their talent from outside the boundaries of the United States. Another issue regarding bonuses is the taxability of the signing bonus when it is paid by a U.S. professional team to a nonresident alien who performs both within and without the United States. The IRS has ruled that a sign-on fee paid by a domestic team to a nonresident alien player as an inducement not to negotiate a player contract with any other team may be allocated under section 863(b) of the Code as partly from income from sources within and partly from sources without the United States.

- The U.S.-source income is subject to withholding under section 1441(a) [see also Chapter 6].

The IRS views a signing bonus as essentially a covenant not to compete or a forfeiture of the right to act (forfeiting the right to negotiate with other teams). Therefore, the IRS contends that the source of the income is the place or places where the promisor forfeited the right to act.

Example 1-3A:

- Eight of ten teams in a league are located in the United States.

Result:

- 80% of the bonus will be taxed as ordinary income.

A statutory withholding tax of 30% (standard rate applicable to nonresident aliens) will apply to 80% of that bonus barring any foreign tax treaty.

The remaining 20% of the bonus will be income from foreign sources.

Note:

- The basis upon which the sign-on fee is allocated as income from sources within and sources without the United States must be reasonable and based on facts and circumstances in each case.
Example 1-3B:

- In some cases, it may be reasonable to make the allocation on the basis of the relative value of the taxpayers' services within and without the United States, or on the basis of the portion of the year during which the sport is played within or without the United States.

- Where a reasonable basis for allocation does not exist, the entire sign-on fee is income from sources within the United States and is subject to the 30% withholding tax.

Note:

- The rules regarding bonuses paid to foreign athletes are the same regardless of whether the contract was entered into in the U.S. or a foreign country. (See also chapter 6.)

INCOME SPLITTING OR ASSIGNING INCOME

A final issue to be addressed in the area of bonus payments is the feasibility of income splitting or assigning income. Due to the progressive structure of the federal tax rates, the total tax liability may be reduced by effectuating an income splitting plan. The logic behind this plan is to legally split income among related parties in order to obtain the benefit of lower tax rates. The key for correctly executing such a device is to plan it in advance and in such a way so it is not nullified by the assignment of income doctrine.
Example 1-4:

- An athlete at the high school level has displayed exceptional physical and athletic prowess on the playing field.
- He is reasonably certain to be offered a signing bonus.
- Therefore, it may be advisable to enter into a *bona fide* written contract with someone such as parent, brother, or sister.
- The contract might require the party to physically train, advise, coach, and negotiate with scouts.
- One way to show that it is in fact a *bona fide* contract is to show that the other party aided significantly in the production of the bonus.

Treatment:

- Upon receiving the bonus, the player includes the entire amount in gross income but is permitted a deduction for a commission paid to the other party of the contract.
- Depending on the size of the bonus and the income of the other party to the contract, it is possible to save in federal taxes if the contract is structured correctly.

Two precedent setting cases in this area are *Cecil Hundley, Jr. v. Comm.* and *Richard A. Allen*.

The Hundley Case

- In *Hundley*, 48 TC 339 (1967), petitioner, a 16 year old high school athlete entered into an oral agreement with his father whereby the father, Cecil Hundley, Sr., would act as petitioner's business agent, trainer, publicity director, and baseball coach.
- Cecil, Sr., had been a major league catcher for many years and had performed a significant amount of coaching since his retirement from professional baseball.

As compensation for his services, Cecil, Sr., was to receive 50% of any bonus received by the son for signing a baseball contract upon graduation from high school.

This agreement was thought to be fair and reasonable because, at the time, it was uncertain whether the petitioner would ever actually sign for a bonus.
Moreover, the maximum signing bonus paid through 1958 was $4,000, so neither party to the contract expected an exceptionally large bonus.

- For two years before signing the contract, Cecil, Sr., attended every practice and game that the petitioner participated in as well as furnishing petitioner with necessary baseball equipment at his own expense.

- Cecil, Sr., also incurred significant expenses when holding meetings (many of which were out of town), with professional scouts in an attempt to publicize the player and his abilities.

- Thereafter, due in large part to the father's expert coaching skills and shrewd negotiating skills, petitioner signed a contract for an extraordinarily large bonus of $110,000.

  - The bonus was to be paid over five years with $11,000 per year going to petitioner and $11,000 going to Cecil, Sr.

- The IRS considered this to be mere income splitting or assignment scheme for the purpose of avoiding taxes.

  - It further argued that the father was an avid baseball fan and probably would have helped his son in the same way even if the oral contract had not existed.

Decision:

- The tax court upheld the petitioner's claim and permitted a $11,000 business expense deduction for each of the five years that he received a bonus payment.

  - The father in turn, claimed an additional $11,000 in gross income.

The Allen Case

A similar but distinguishable case from Hundley where a taxpayer tried to assign income to a related party was Richard A. Allen v. Comm., (1969) CA-3, 410 F2d 398.

- Petitioner, Dick Allen, was awarded a significant bonus to sign a professional baseball contract with the Philadelphia Phillies.

- A large portion of the bonus was paid directly to his mother upon her request and petitioner's consent to allegedly compensate her for enticing petitioner to "do the right thing."

- The petitioner argued that the payments received by his mother ($40,000 over five years) were not part of his signing bonus. Rather, they represented compensation paid to her by the Philadelphia Phillies organization in return for influencing petitioner to sign with the Phillies and giving her parental consent thereto.
In nullifying the income assigning plan, the IRS and the Court held that the player alone was the source of the income, and considering that the mother knew nothing about baseball or negotiating contracts, she did not play a significant role in the production of the bonus.

Additionally, there was no evidence of any written or oral agreement that existed between Allen's mother and the Phillies. Therefore, the entire amount of the bonus would be included in petitioner's gross income.

Conclusion: When executing an income splitting plan, it is imperative that a bona fide agreement exist and that both parties to the contract aid in producing the bonus.

COLLEGE SCHOLARSHIP PLANS

A large percentage of athletes who accept signing bonuses are either recent high school graduates or players who are drafted before they complete their college degree. Realizing that the majority of athletes that get drafted never spend a day in the major leagues, major league baseball has incorporated a plan whereby a professional team agrees to pay remaining college education expenses of certain selected players.

Although this plan should be incorporated into every entry level contract, it is not as beneficial as it sounds. The provisions of the plan limit the amount that a team may pay to $1,500 per semester and/or $12,000 in the aggregate. This $12,000 will barely cover one year of college for an athlete who aspires to attend a private institution. The unconditional release of a ball player does not exonerate the team from its obligation to make payments under the plan. However, the club is relieved of the obligation if the taxpayer fails to report to spring training or fails to comply with other reasonable instructions from the professional team.

TAX TREATMENT

The IRS has held that amounts paid to a college on a ballplayer's behalf are not excludable from gross income.

However, Section 117 provides, in part, that gross income of an individual does not include an amount received as a scholarship at an educational institution or as a fellowship grant.

Reg. Sec. 1.117-4 provides that amounts paid or allowed to, or on behalf of, individuals to enable them to pursue studies or research are considered to be amounts received as a scholarship if the primary purpose of the studies is to further the education of the recipient.

Therefore, the amount provided by the grantor does not represent compensation for services.
COMPENSATION

- If such amounts do represent compensation for past, present, or future services, they should not be considered received as a scholarship and thus may not be excluded for purposes of Section 117.

- Considering the aforementioned facts, the IRS has ruled that amounts paid under the scholarship plan on a player’s behalf constitute wages.

  - Consequently, the player is responsible for paying income taxes on such amounts.

TAX PLANNING FOR COMPENSATION

Many athletes and entertainers are highly compensated for their activities and their peak income earning periods are relatively short. There must be an adequate amount of income when their career is over. The goal, therefore, is to preserve capital and minimize tax liabilities and still have sufficient income to live the kind of life that today’s athlete/entertainer has or will quickly become accustomed to. In short, they must plan for lifelong financial security and prosperity during the short time they produce income.

However, new legislation and higher tax rates have created the need for certain tax planning techniques. The following is a discussion of popular planning techniques that are still useful (see also Chapter 3).

GENERATING PASSIVE ACTIVITY INCOME

Passive activity losses may be offset only against passive activity income. It may be possible to convert income into passive activity income by giving entertainers an equity interest in a film, e.g., as a limited partner, rather than giving them contingent deferred compensation. The individuals could shelter passive income generated against passive activity losses from other sources, including tax shelters. However, the IRS has broad discretion in the passive activity loss area, and may characterize all income from such an equity interest as service income and not passive income.

DEFERRED COMPENSATION

Not too long ago, the tax rate on personal income ranged as high as 90%. In addition, athletes or entertainers were not making the exorbitant sums of money that they are today. Consequently, there were obvious advantages to deferring income to later years when it was possible if not probable that the athletes or entertainers would be in an overall lower income tax bracket. Since the highest tax bracket is now 39.6%, and it is not expected to decline substantially, if at all, deferred compensation is still used today.
Income Recognition

Additionally, since the average salary for a professional athlete in the four major sports was in excess of $800,000 in 1995, (basketball and baseball averaged $950,000), the chances are that with a few fair investments, athletes will extend indefinitely the years at which they can be taxed at the highest level. According to some investment and tax advisors, it is beneficial for athletes to defer recognition of income and accelerate deductions due to the increase in tax rates.

Potential for Deferred Compensation

The potential advantages of deferred compensation should be considered. Considering facts and circumstances on an individual basis, there are opportunities for athletes or entertainers to benefit.

Example 1-5:

- A young, uneducated (in financial matters) athlete who receives a large signing bonus may have the propensity to spend it on fast cars and designer clothes.

- Assuming the athlete suffers a career-ending injury before ever reaching the parent team level, he may be left with a $125,000 Mercedes Benz, (which is constantly depreciating in value) and another $100,000 of fond memories.

Discussion:

- Of course this example may be overly simplified and exaggerated, but it has happened and will happen again.

- An athlete who provides for deferred compensation is, in essence, investing in a financial planning device that will provide a steady source of income and eradicate the temptation to spend frivolously during peak income producing years.

In evaluating the potential benefits of a deferred compensation plan, a tax or financial advisor must ascertain whether the total projected amount of the plan, discounting for the time value of money and inflation, is actually greater than if the athlete had received the money, paid tax at the highest rate, and then made investments.
Constructive Receipt

A final issue that must be addressed regarding deferred compensation is the "constructive receipt" doctrine. This rule is explained and exemplified in Rev. Rul. 60-31:

- Where a contract provides for deferred compensation, the taxpayer is not taxed until the year in which the money is actually received.

Example 4 of Rev. Rul. 60-31 provides an exception to the rule:

- It involves a professional football player who received a signing bonus for $150,000 as an inducement to enter into the contract.
- The contract included a clause that the player could have demanded and received the money at the time of signing the contract but instead decided to incorporate a clause that would pay the money to an escrow agent designated by the player.
- The escrow agent then agreed to pay this amount, plus interest to the player, over a period of five years.
- Since there was an economic or financial benefit conferred on the player in the year of signing the contract, the money was considered to be includible in gross income for the year in which the team unconditionally paid the money to the escrow agent.

Another precedent setting case in the area of deferred compensation which concluded in a more favorable way was Robinson v. Comm., (44 T.C. 20, 1965):

- Sugar Ray Robinson was a professional boxer who entered into a contract with the International Boxing Club to engage in a fight to defend his world title.
- The IBC was responsible for all promotion of the fight.
- Under the contract, Robinson was to receive 45% of all gate receipts, and the payments were to be received over a three-year period.
- The commissioner argued that the entire amount was constructively received and should be included in Robinson's gross income in the year of the fight (1957).
- The court rejected this argument, stating that once the contract was signed, Robinson's funds were commingled with IBC funds and no separate escrow account was established.

- Therefore, Robinson's contractual arrangement avoided the constructive receipt doctrine because he was a general creditor and took the risk of loss.
Conclusion:

- It is imperative that expert counsel be sought when considering the possibilities of deferred compensation plans so as to avoid unfavorable results.
- Also, athletes/entertainers must try to maximize deductibility of expenses and try to shift large deductions into years of high income. (See Chapter 2).

ENDORSEMENT INCOME

In these days of skyrocketing salaries paid to athletes, the market for personal appearances in conjunction with the promotion and endorsement of products and services is also very lucrative.

Many athletes are paid large sums of money in exchange for their time to pitch certain products. Any type of compensation, including in-kind payments that an athlete receives for these appearances, promotions or endorsements—including money, goods or services—must be included in gross income. In Hornung v. Commissioner, the Tax Court ruled that an athlete's use of a car furnished by an automobile dealer in exchange for Mr. Hornung making appearances for the dealer was not a tax-exempt gift, because there was no "detached and disinterested" generosity; rather, it was income, because Mr. Hornung received an economic benefit in return for his endorsement of the product.

In addition, it appears the IRS can apply the holding in Hornung v. Commissioner to professional athletes who receive sports apparel, such as sneakers, golf clubs, and other training merchandise, in lieu of a cash payment.

Although it appears that an athlete/entertainer must include these "benefits" in income, they are allowed to deduct any expenses in connection with their appearances (i.e., travel, meals). Any income that an athlete/entertainer earns from endorsements can be sheltered via the use of a Keogh/SEP.

DISABILITY PAYMENTS

Payments received under a private contractual agreement that doesn't have the force and effect of law are not under a statute in the nature of a worker's compensation act. For example, disability payments to a pro football player who sustained career-ending injuries, paid under an agreement between the players' association and the league, were held to be includible in income [Beisler v. Commissioner, TC Memo 1985-25, 49 TCM 534, aff'd 787 F2d 1325 (9th Cir. 1986)].
Most athletes/entertainers are highly compensated. However, especially for athletes, the peak earning years may be quite few. And, the IRS has been cracking down on income from outside activities such as card shows, etc. Therefore, it is imperative that compensation be structured for maximum tax advantage.

We have discussed advantageous use of bonuses, deferred compensation, and generating passive income. Use of these planning ideas should be most effective for your athlete/entertainer clients.
Directions:

■ Take a few minutes to read the questions.

■ Be prepared to discuss your responses.

■ Use the space provided for your notes.

M, a football player, enters into a contract with a team in which he agrees to play for the team for a two-year period. As an inducement for signing, M was offered a $500,000 bonus. M could have demanded and received payment of bonus at the time of signing the contract, but at M’s suggestion the contract provided that the bonus be paid to Bank Y, as escrow agent.

Under the escrow agreement, Bank Y agreed to pay the bonus, plus interest, over a five-year period upon the expiration of M’s contract, including renewals, with the team.

Is the signing bonus includable in M’s income in the year in which he signs the contract or in the year in which the installments are paid by the escrow agent?

Notes:
Donald Formino, a very successful college baseball player, was the fourth player selected in the first round of Major League Baseball's Amateur Draft. As an inducement to signing a contract, Don has been offered a $425,000 signing bonus. Don has the option of receiving this bonus in a lump sum on July 1, 1995, or in two installments (July 1, 1995 and January 15, 1996). Andy Oddo, Donald's agent, will receive 3% of the signing bonus as an agent fee.

Mr. Formino has approached your firm for tax advice regarding the signing bonus. Prepare a list of objectives and planning ideas for Mr. Formino.

Notes:
At the time the contract was signed, M could have demanded payment of the bonus. Restrictions and limitations were then imposed on the payment of the bonus through the escrow agreement.

The act of signing entitled the player to request immediate payment of the bonus. Consequently, in the year in which the contract was signed, a financial or economic benefit was conferred on the player.

Treatment:

The $500,000 signing bonus is includable in the player’s gross income in the tax year in which the team unconditionally pays the bonus over to the escrow agent. [Rev. Rul. 60-31]
List of Objectives and Planning Ideas:

- Consider the time value of money, tax rates, and investment opportunities in deciding when Donald should receive the bonus.

- Structure the signing bonus to minimize Donald's federal and state tax liability.

- Utilize possible exceptions when considering income tax withholding on the signing bonus.

- Consider the bunching of itemized deductions to escape the 2% and 3% floors.

- Prepare a budget for Mr. Formio.

- Consider prepaying state and local taxes.

- Consider the effect of alternative minimum tax on any plans for bunching or accelerating deductions and expenses.
CHAPTER 2
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

OBJECTIVES

■ Advise clients on the deductibility of expenses.

■ Devise a comprehensive plan to maximize deductible expenses pertaining to athletes/entertainers.

INTRODUCTION

Section 162 allows taxpayers to deduct all "ordinary and necessary expenses incurred in carrying on a trade or business." Once athletes achieve professional status, they are considered to be in the trade or business of being an athlete. The term trade or business can also include services performed as an employee.

PERFORMING SERVICES AS AN INDIVIDUAL

Business Deductions and AMT

Generally, the most influential aspect in planning occurs with business-related deductions if these trigger the alternative minimum tax (AMT). Accordingly, attentive planning for AMT can produce the greatest tax savings. Most performing and creative artists have various sources of revenue during any given year. The character of the work relationship should govern whether the income is reported as wages or self-employment income, and similarly whether the related business expenses are to be reported on Schedule C (not affected by the floor or ceiling) or Form 2106 (limited to the excess over 2% of AGI and perhaps by the AMT). As a practical matter, however, the reporting on the client’s return should normally follow the reporting by the payer (i.e., if reported to the client on a Form W-2, the income would be reported on the income tax return as wages, whereas if reported to the client on a Form 1099, the income would be reported on the income tax return as self-employment income). Obviously, due to the preferential treatment accorded "above-the-line" deductions, as well as the additional potential benefit of reducing any limitation based upon AGI, it is usually desirable to relate as many business expenses as possible to the self-employment income and as few as possible to the wage income.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

AWAY FROM HOME EXPENSES

When an athlete begins a professional career, whether on the minor league level or parent team, and often many times throughout the career, he often has to uproot himself and his family and move to the location of the team. This move is often temporary; being anywhere from weeks to several months. The athlete obviously will incur expenses for rent, food, and local travel to the athletic facility, just to name a few.

TAX HOME

How are these expenses treated? The definition of "tax home" for purposes of Section 162 for a professional athlete or entertainer is surrounded by a tremendous amount of controversy.

A child actor and his mother lived in New York City, away from their family home, during two years he was on the New York stage. The Tax Court decided the taxpayer went to New York with the intent of staying for as long as he could find employment in the acting profession. His stay was indefinite, and New York City was his tax home [Kroll, 49 TC 557 (1968)].

In Rev. Rul. 75-432 as well as Stidger v. Comm., (368 U.S. 287, 1967), the IRS has taken the position that the term "tax home" refers to the business location or duty station of the taxpayer. The Tax Court has upheld this assertion, but many Circuit Courts still maintain that "tax home" refers to the principal residence of the taxpayer.

Since the view of the Tax Court and the IRS is the more accepted position, the athlete should assume that, except in those circuits where the court of appeals has adopted a contrary view, "home" is the principal place of business or the "club town."

In Wills v. Comm., [411 F2d 537 (9th cir. 1969)], the taxpayer maintained a principal residence in Spokane, Washington but was employed as a professional baseball player by the Dodgers in Los Angeles. The Court held that expenses incurred for rent, food, local transportation, etc., were nondeductible personal expenses. Additionally, the expenses of traveling between his residence and place of business were held to be personal in nature.

Indefinite vs Temporary Employment

In the case of a minor league player, it is possible to be assigned to as many as two or three teams in a seven-month period. The IRS held in Rev. Rul. 54-147 and restated in Rev. Rul. 75-432 (in addition to private letter rulings), that a minor league player or any team sport athlete is an itinerant who can never be away from home because he carries his home with him to each temporary work location or "club town." The IRS has noted the key determinant in such cases to be the indefiniteness of employment as opposed to the employment actually in fact being temporary. There are certain circumstances where the Tax Court and IRS recognize that the taxpayer may be "away from home" on a temporary (as opposed to an indefinite) work assignment because he is away from his regular or principal place of employment or, if none, the regular place of abode in a real and substantial sense.
For example:

- An all-star catcher for the parent team injures his finger, and it is reasonably determined that he will be unable to play for two weeks.

- A minor league catcher is called up to fill his role; therefore, it would be a *bona fide* assessment to hold that the minor league player was on a temporary work assignment "away from home."

- He would be permitted to deduct ordinary and necessary expenses while playing for the parent team for that two-week period.

For a temporary characterization to apply, it must be foreseeable at the time of acceptance of such employment, that the period away from the previously established tax home will terminate within a reasonably short period of time.

It is important to note that for cases such as this one, a unique set of facts and circumstances will govern and determine each outcome. When athletes are away from their club town on business (playing "away" games), they may deduct any reasonable expenses incurred for meals, lodging and travel to the extent they are not reimbursed.

*Spouse/Family Expenses*

Athletes or entertainers who bring their families or spouses with them when they are considered to be "away from home" are not permitted a deduction for these expenses unless it can be shown that the spouse is a bona fide employee and the expense is in the ordinary course of business.

*Nonteam Sport Athletes*

The "away from home" and traveling expense rules are applicable to *nonteam sport athletes* who are required to travel to numerous different places as the site of the competition changes. In the case of professional golfers, tennis players, boxers, or jockeys, they do not have a principal workplace nor are they considered an itinerant. Instead, they are treated as if they maintain a principal place of abode and are considered to be away from home when traveling to and staying overnight at the event's location. Accordingly, athletes will be permitted a deduction for all ordinary and necessary expenses incurred in connection with their respective athletic events (see *Pierce v. United States*, 271 F. Supp. 166, 1967; *Lucien Boyer*, 36 TCM 1329, 1977).

For example:

- A boxer who is a resident of New York and schedules a fight in Las Vegas would correctly be permitted to deduct all ordinary and necessary expenses he incurred in connection with the fight.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

- These "away from home" expenses would probably be permitted even if the boxer traveled to Las Vegas weeks prior to the fight to continue training and conduct public relations events.

The Energy Act of 1992 treats a taxpayer's employment away from home in a single location as indefinite rather than temporary if it lasts for one year or more. Thus, no deduction would be permitted for travel expenses paid or incurred in connection with such employment. As under prior law, if a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite would be determined on the basis of the facts and circumstances. This change is effective for costs paid or incurred after Dec. 31, 1992.

TWO OR MORE BUSINESSES

In managing their financial affairs, players often enter into additional "side" businesses or "off-season" businesses. In such cases, the taxpayers "home" for purposes of traveling and expense deductions will be the location of the principal place of business, and the taxpayer will be entitled to deduct expenses while away from that principal place of business.

PRINCIPAL PLACE OF BUSINESS

In determining the principal place of business, Rev. Rul. 54-147 states three important factors to consider. They are:

1. The amount of time spent at each business,
2. The amount of business transacted at each place of business, and
3. The financial return of each business.

For example:

- If a football player for a New York team owns a restaurant in Canton, Ohio, expenses incurred for travel and lodging near the restaurant for the purpose of overseeing its operations will be a deductible away from home expense.

- This rule will hold even if the taxpayer's principal place of abode is in Ohio (Rev. Rul. 54-147).

Two Separate and Distinct Sports

An interesting issue arises in the case of a professional athlete who engages in two separate and distinct sports (i.e., baseball and football) A valid argument could be made that the taxpayer is an itinerant and carries his home with him. On the other hand, a position could be taken, considering the criteria
mentioned above, that the athlete spends more time with one sport, makes more money from that sport, and is legally bound to complete a full season with that respective sport before engaging in the other sport, and therefore, expenses incurred in the second sport are "away from home" expenses.

Note: The unique facts and circumstances in each case will determine the outcome.

OTHER DEDUCTIONS

There are several types of deductions that may be available to professional athletes/entertainers; some apply only to athletes/entertainers and some are applicable to all taxpayers.

AGENT'S SALARY/COMMISSION

The first deduction that is very significant to the athlete/entertainer is a salary or commission to an agent. In today's society, athletes and entertainers often sign complex and very lucrative contracts so they find it beneficial to leave these negotiations to an expert. Additionally, agents act as public relations directors or promoters for the athlete/entertainer and are responsible for obtaining endorsements.

As a general rule under Section 162, a taxpayer may deduct salaries or other compensation paid for personal services rendered to the taxpayer. The test of deductibility is twofold.

First: The compensation must have been paid solely for services and for no other reason.

Second: They must be reasonable in amount.

As discussed above, agents often provide a wide range of services to the professional athlete/entertainer and are usually compensated on a contingency basis (fixed percentage of income).

A question arises as to what is a reasonable amount. Under Reg. Sec. 1.162-7(b) (2), the form and method fixing compensation is not decisive as to its deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings from the enterprise, (athlete's/entertainer's income), it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate.

Two precedent-setting cases in this area are Hundle v. Comm., (48 T.C. 339, 1967) and Allen v. Comm., [(1969), CA-3, 410 F2d 398]. In Hundle, the Tax Court agreed with petitioner that 50% of a signing bonus the athlete paid his father (agent) was a deductible business expense to the petitioner.

- Although the agent's fee was extraordinarily high, ($55,000), the athlete and agent entered into the oral contract before any services were begun before either party knew what amount, if any, the signing bonus would be.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

- A significant reason why the bonus was so high was due to the shrewdness the agent possessed in negotiating the contract and because of the expert knowledge he imparted to the athlete that enabled the athlete to reach his potential.

In the Allen case, the compensation paid by petitioner to his mother was held to be unreasonable and thus not deductible.

- The mother was not a significant factor in her son’s development as a baseball player.

- Additionally, she did not possess negotiating skills and therefore was not held to be instrumental in the amount of the signing bonus.

OTHER AVAILABLE DEDUCTIONS

Maintaining Peak Physical Condition

One such deduction covers expenses paid for maintaining peak physical condition. Athletes generally are permitted to deduct off-season conditioning expenses, such as health club membership fees (to the extent that they are reasonable) and athletic apparel (sneakers, jogging suits, etc.).

A possibility exists to write off the purchase of a swimming pool (lap pools only. The kidney-shaped pool surrounded by a waterfall won’t fly.) The determining element in such cases is that the expenses must be incurred in connection with the athletes’ maintenance or betterment in their respective sports.

In one case (Stemkowski v. Comm., 690 F2d, 40, 1982), some of the more outlandish expenses a professional hockey player sought to deduct were expenses of playing golf, bowling with his girlfriend, and having his hair styled. He claimed that the golf helped relax him and take his mind off hockey, the bowling was part of his physical training, and his hair style was related to and helped enhance his marketability and public image as a hockey player. The courts properly disallowed these expenses as personal in nature. Regarding the bowling and golf, the courts reasoned that not all expenses of engaging in conditioning activities are related to the taxpayers business of being a hockey player.

Entertainers’ Physical Appearance

Physical appearance expenses such as makeup or cosmetics, hairdressing, physical conditioning (e.g., personal trainer fees, health club dues, massages, facials, purchase or rental of exercise equipment, etc.) and cosmetic surgery and dentistry have been deducted, almost routinely, by performing artists. Based upon mostly anecdotal evidence of audit results, these deductions for performing artists have been defended from IRS attack generally with at least partial success. There have also been, however, notable taxpayer victories in court. A significant older case is Hutchinson, 13 BTA 1187 (1928), where the court sustained these types of deductions for an actor. In this case, the court allowed deductions for massage, physical trainer fees, rental of gym facilities, and other related costs which an actor incurred to maintain the “first-class condition” expected in his profession. In another, far more recent, taxpayer victory, Hess, Reginald R., T.C. Summary Opinion, 1994-79, the wife, an exotic dancer known as “Chesty Love,” was
permitted to depreciate the cost of breast implant surgery as it was found to have been incurred solely in furtherance of her business and not for personal reasons. Unfortunately, because this case is a Tax Court Summary Opinion, it has no precedential value, but does demonstrate the Tax Court can be open-minded when presented with solid fact patterns. Irrespective of the past, this is another category of deductions which can be expected to be more difficult to successfully defend under the MSSP (see end of chapter). Unlike the various categories of research expenses, however, the expenses for maintaining or improving one's physical appearance do not fall into the documentation net of Sec. 274. Accordingly, the IRS does not have a powerful statutory weapon, such as Sec. 274, to aim at deductions for physical appearance. This lack of specific authority, however, has not prevented the IRS from stipulating to MSSP auditors that these deductions are inherently personal in nature and should be disallowed without a specific connection to a particular source of revenue. Considering the way these deductions have had judicial scrutiny in the past, the IRS may be taking too harsh a position on this subject. While it would be wise, in light of the anticipated aggressive, adversarial posture from the IRS, to improve the quality of documentation to support such deductions, they may still be viable if handled with care.

Miscellaneous Deductions

Other expenses an athlete/entertainer will be able to deduct are expenses for trade journals, answering fan mail "promotional" activities, costs of maintaining a telephone, television and VCR for business, and uniforms, theatrical clothing, and accessories not suitable for ordinary use (not an exhaustive list), see also below.

Note:

- These "miscellaneous expenses" are deductible only to the extent they exceed two percent of the athlete's adjusted gross income, if employee.

Additionally, it is imperative for athletes and entertainers to maintain a complete set of records to substantiate any expense deductions as required by Section 274 (d). In Stemkowski, petitioner would have been permitted by the United States Court of Appeals for the Second Circuit to deduct many (some mentioned above) expenses related to his business of being a hockey player. However, Stemkowski was unable to show substantiation for these expenses and therefore they were denied.

Wardrobe

An area which is straightforward for the average taxpayer can become complicated for celebrity clients. With wardrobe, however, it is generally performing artists (when comparing performers and creative artists) who incur high wardrobe costs and may seek to deduct some or much of it. Unfortunately, for these taxpayers, the argument they must always carry their image, and, therefore, their clothing to maintain that image is deductible will no more work for them than the well-dressed business person. For any taxpayer to secure a valid wardrobe deduction, the clothing must not only be inextricably tied to the ordinary and necessary performance of their duties in their trade or business, but must also be unique in such a way as to not otherwise be useable in a common, everyday, nonbusiness setting. Consequently, it
is generally as a uniform or as clothing with a special purpose usage that wardrobe may qualify for an income tax deduction. Accordingly, performers will usually look to the special purpose usage concept (i.e., costumes) to gain deductions. An interesting dilemma may arise for popular musicians who start clothing trends by wearing clothing not customarily seen in public. At what point does an article of performance wardrobe take on the aura of clothing suitable for everyday wear? How much will the musician's use of the clothing offstage to perpetuate their image hurt the unique aspect of the garment? Does the public’s adoption of "the look" signal the wardrobe is suddenly acceptable for everyday usage? While most case law involving performers supports the plain meaning of the statute, some notable exceptions exist. An example is Regan v. Commissioner, T.C. Memo, 1979-340, 1979, where an actor was permitted a deduction for "period" clothing representative of the '30s which was purchased for a play about that era. This raises questions about how old must clothing be for it to be considered out of style, especially since we have witnessed trends that recycle old styles. The most taxpayer-favorable decision in this area, however, stands alone and is virtually in complete contradiction of the statute. The decision in Nelson et al., T.C. Memo, 1966-224, filed October 11, 1966, upheld the taxpayer's deduction of contemporary clothing suitable for personal wear because the taxpayer proved the garments were used solely for the TV show on which he appeared. These last two examples demonstrate that the courts have been willing to consider broad interpretations of law and aggressive arguments on behalf of taxpayers. Clearly, it is not a foregone conclusion to abandon wardrobe as a deduction without first considering the uniqueness of every given situation.

**Bunching Itemized Deductions**

Taxpayers may consider the opportunity to bunch items as deductions.

*Charitable Contributions*

Charitable contributions can be easily bunched by using a private foundation, pledges, a local community foundation, or by working through charitable or religious organizations.

*Investment Interest*

Investment interest is not an itemized deduction subject to the 3% phaseout. However, home mortgage interest may be subject to the disallowance. A taxpayer may be able to arrange with the lender to make payments in alternating years, or to make payments funded by a home equity loan from the same lender which may not be considered a payment by a cash method borrower.

*Bunching Strategy*

Adoption of a bunching strategy requires careful planning. The impact of possible late payment penalties, the effect of the time value of money on the after-tax proceeds, and the potential to become subject to the alternative minimum tax in the "itemized deduction years" all need to be carefully taken into account.
This strategy is most successful when the amount of itemized deductions to be shifted is relatively close to the amount of itemized deductions which will be disallowed. If this is the case, it will not be necessary to shift a large amount of deductions in order to preserve the deductibility of the remaining itemized deductions equal to 3% of AGI.

CAR EXPENSES

Car expenses incurred in connection with travel for business purposes are deductible from gross income to the extent that the expenses are attributable to business- or income-producing use, rather than to personal use. The IRS has authorized two methods to use in computing car expenses: the actual cost method and the standard mileage rate method.

*Standard Mileage Rate*

Generally, professionals are free to use the method that produces the largest deduction. However, the standard mileage rate method may not be used to compute the expenses for a vehicle used for hire or by those who simultaneously use two or more cars in their business.

Moreover, the standard mileage rate method may be used only if this method had been used in the first year that the car was placed in service for business purposes. Those who elect the standard mileage rate method in the first year a car is placed in service may, in the next year, elect to use either of the two methods to determine the amount of the deduction.

**Note:**

- Unreimbursed employee business expenses must be taken as itemized deductions, subject to a two-percent floor on the aggregate amount of miscellaneous deductions.
- Regardless of whether an employee elects the actual cost method or the standard mileage rate method, any unreimbursed expenses must be itemized and are subject to the two-percent limitation.

*Standard Mileage Rate Method*

An athlete/entertainer can use the standard mileage rate method for only one car at a time and only for a car that she owns. Thus, the standard mileage rate is not available to an athlete/entertainer who leases cars or who uses two or more cars simultaneously in a trade or business. However, if an athlete/entertainer uses different cars on different occasions for business purposes, she can apply the standard mileage rate to the total business use of such cars. The rate for 1998 is 32.5¢. On December 24, 1998, the IRS issued Announcement 99-7, which postpones until April 1, 1999, the effective date of the 31 cents per mile rate set in Rev. Proc. 98-63.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

Where a person uses different cars on different occasions for business purposes, the standard mileage rate usually applies to the total business mileage of such cars as if they were one. Likewise, if a car is replaced during the year, the total business mileage of both cars for the year is usually used in applying the standard mileage rate.

Actual Cost Method

All operating and fixed costs connected with maintaining a car used for business purposes are deductible. Items such as depreciation, maintenance and repairs, tires, gasoline, gasoline taxes, oil, insurance and registration fees are among these costs. Parking fees and tolls attributable to using a car in business may be deducted as separate items. Although the cost of the car itself is not deductible as a business expense, as is the cost of any replacements that prolong the useful life of the vehicle or increase its value, the cost of the car is depreciable.

If athletes/entertainers use a car for both business and personal purposes, they must allocate car expenses between business and personal use. The amount of an athlete’s/entertainer’s car expense deduction can be determined by multiplying the total amount of actual expenses by a fraction:

- The numerator of which is the number of miles driven for business purposes and
- The denominator of which is the total mileage, business and personal.

Actual Cost and Standard Mileage Rate Methods Compared

Seriously consider using the standard mileage rate. Not only is the substantiation requirement less—the taxpayer needs only to verify miles, not expenditures—but the total auto expense deduction may be greater.

COMMUTING EXPENSES

The costs of traveling between a home and principal or regular place of business or employment are considered to be personal expenses, and, accordingly, are not deductible. However, if the professional has a minor or temporary assignment beyond the general area of his tax home and returns home each evening, the expenses of the daily round-trip transportation are deductible. Commuting expenses include the cost of taking a bus, trolley, subway or taxi or operating a car.

- In Rev. Rul. 90-23, the IRS stated that people with regular places of business who go directly from home to any temporary site to work on an irregular or short-term basis may deduct the cost.

Example: Mr. CPA works for a firm with offices in downtown Atlanta.

The normal round-trip distance between his office and home is 76 miles.

Occasionally, he works at a client’s office, which is an 86-mile round-trip from his home.
Conclusion: When he works at the client’s office, the mileage is deductible, since the client’s office is a temporary location.

The distance a person must travel to work generally has no bearing on the nondeductibility of commuting expenses.

For example: Several courts have held that the costs of traveling to and from permanent or indefinite jobs in remote areas are nondeductible commuting expenses, even though neither public transportation nor housing is available near the job site.

TRADE-INS

If a car is acquired by trade-in of another vehicle previously used in business, any gain or loss on the business portion of the car traded in must be taken into consideration in determining the depreciable basis of the new car.

POST-1986 RULES

Under MACRS, cars are classified as five-year recovery property. Thus, the percentages for claiming depreciation on cars under MACRS are generally to be determined on the basis of the half-year convention, the 200-percent declining-balance method with change to straight-line to maximize the deduction, and a five-year recovery period.

This would generate the following percentages:

- 1st year — 20%;
- 2nd year — 32%;
- 3rd year — 19.2%;
- 4th year — 11.52%;
- 5th year — 11.52%; and
- 6th year — 5.76%. [See table next page]
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

<table>
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If more than 40% of the total bases of the property placed in service during any tax year is placed in service in the last quarter of that year, then the mid-quarter convention is to be used instead of the half-year convention. This convention assumes that any property placed in service in a quarter of the tax year is considered placed in service at the mid-point of that quarter.

Thus, if the only asset placed in service in 1991 is a car that is placed in service in the last quarter, the percentages would be:

- 1st year – 5%;
- 2nd year – 38%;
- 3rd year – 22.8%;
- 4th year – 13.68%;
- 5th year – 10.94%;
- 6th year – 9.58%.

Under the alternative method, athletes/entertainers are to use the straight-line over a five-year recovery period. The percentages would be: 1st year, 10%; 2nd through 5th years, 20%; and 6th year, 10%.

Note: The Section 179 expensing deduction was raised to $18,500 from $10,000 effective for property placed in service after December 31, 1997.
HOME OFFICE EXPENSES (SEC. 280A)

1997 law — 1. Soliman overridden: A home office will qualify as a taxpayer's "principal place of business" if (1) the office is used to conduct administrative or management activities of the business and (2) there is no other fixed location of the business where substantial administrative or management activities are conducted. This new rule overrides the Supreme Court's decision in Soliman, 93-1 USTC ¶50,104, which held that a principal place of business was where the primary income-generating functions of the business were performed. This new rule will allow many taxpayers to deduct not only costs associated with their home offices but also the cost of traveling to and from their home offices to other business locations; those expenses were previously nondeductible commuting expenses. Effective date: Tax years beginning after 1998 [Sec. 280A(c)(1), amended by TRA '97].

2. For tax years beginning after 1995, a taxpayer can deduct expenses related to the portion of her home that is used regularly (but not necessarily exclusively) for the storage of product samples (in addition to inventory, as currently). The taxpayer must be in the business of selling products and the home must be the sole fixed location of the business [Sec. 280A(c)(2), amended by the SBA '96].

Overview: Taxpayers can deduct expenses attributable to a home office used in business if the home office qualifies under one or more of the following tests:

- It is the principal place of business for any trade or business of the taxpayer;
- It is a place of business used to meet customers, clients, or patients; or
  - It is a separate structure used for business, which is not attached to a dwelling.

The home office must be exclusively used on a regular basis for one of the above purposes. In the case of an employee, the exclusive use must be for the convenience of the employer [Sec. 280A(c)].

Principal place of business: Taxpayers can have a principal place of business for each trade or business in which they engage.

Business at multiple locations: Taxpayers can have more than one business location, including their home, for a single trade or business. To deduct expenses for the home's business use, the home office must be the principal place of business for that trade or business based on all the facts and circumstances. The primary factors are [Soliman, 113 S Ct 701, 93-1 USTC ¶50,014 (S. Ct. 1993)]:

- The relative importance of the activities performed at each business location; and
- The amount of time spent at each location.

Comparing relative importance of the activities at each location: See discussion of Rev. Rul. 94-24 below.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

Time spent at each location: Taxpayers should also compare the amount of time spent on business at their home office with the amount of time spent on business at other locations. Note: The time consideration is particularly significant when a comparison of the importance of the activities performed at each business location yields no clear answer to the location of their principle place of business. For example, this might happen when taxpayers perform income-generating activities at both their home office and some other location.

Further IRS guidance on Soliman: The IRS issued a revenue ruling illustrating how it will apply Soliman's "relative importance" and "time" tests to determine whether a home office is the taxpayer's principal place of business. In the ruling, the IRS said that a comparison of the relative importance of the activities performed at each location depends on the characteristics of the particular business, and if that business requires the taxpayer to meet with clients or to deliver goods or services to clients, the place where the contact occurs must be given great weight in determining where the most important activities of the business take place. The IRS said that the relative-importance test will be applied first to determine whether a home office is the taxpayer's principal place of business, and only if that test yields no definitive answer will the time test be applied. The IRS added that in some cases the application of both tests might result in a finding that there is no principal place of business for purposes of Sec. 280A(c)(1)(A). See Rev. Rul. 94-24, 1994-1 CB 87.

Exceptions: There are two exceptions to the exclusive-use test of Sec 280A(c).

The dwelling is the only fixed location of a trade or business consisting of selling products at retail or wholesale and a separate identifiable portion of the residence is regularly used for storage of inventory and, after 1995, product samples.

A residence is used on a regular basis to provide day care services to children, handicapped individuals and the elderly (see page 4-82).

Telephone: An individual cannot deduct the cost of installing or maintaining his first telephone line or the charge for local phone service for a telephone at his home. This does not affect the deduction for long-distance charges, equipment, or optional services (e.g., call waiting, etc.), or charges of additional phone lines [Sec. 262(b)].

Investment activities: A taxpayer who maintains an office at home for investment activities that don't amount to a trade or business is not allowed a deduction, whether or not he is also employed.

Limit on deduction [Sec. 280A(c)(5)]: Suppose the gross income from the business use of taxpayer's home equals or exceeds the business expenses (including depreciation). Then the taxpayer can deduct all of the expenses from the home's business use. However, if the gross income from that use is less than the taxpayer's total business expenses, the deduction for certain expenses for the home's business use is limited. The total of the taxpayer's deductions for otherwise nondeductible expenses, like utilities, insurance, and depreciation (with depreciation taken last) cannot be more than the taxpayer's gross income from the home's business use less the sum of:
• Business percentage of the otherwise deductible mortgage interest, real estate, taxes, and casualty and theft losses; and

• Business expenses that are not attributable to home's business use (for example, salaries and supplies).

If certain expenses for the business use of the home are more than the above limit, taxpayers can carry the excess amount forward to the next year when computing their deduction limit for the business use of their home for that year, whether or not they use their home as a residence during that year.

Space allocation: In determining the portion of the residence allocable to business use, the taxpayer may compare the number of rooms (if they are of similar size) or the number of feet of floor space.

As for the exclusive-use requirement, the IRS will accept any "separately identifiable" area as a home office. This means that it does not have to be a separate room or a portion that is "marked off by a permanent partition."

Day care providers [Sec. 280 A(c)(4)]: Generally, as noted above, there is no deduction for a home's business use unless part of the residence is used exclusively and regularly for business. However, an exception applies to day care providers. They can claim a deduction even if the part of the residence regularly used for day care is also used for personal purposes.

A day care provider can calculate the deduction by treating a room as used for day care for the entire business day if it's available for day care and is regularly used for this purpose (Rev. Rul. 92-3, 1992-1 CB 141).

Example

Mary Greene, a licensed day care provider, operates a full-time facility in her home 11 hours each day, 250 days per year. She spends one-half hour before and one half-hour after regular business hours preparing for and cleaning up after the children. Her home has a total floor area of 1,600 square feet. Although no rooms in Mary's home are used exclusively for her day-care business, several rooms in her home are available for day care use throughout the business day and are regularly put to day care use. The total area of these rooms is 1,200 square feet. Mary Greene's total home costs for the year (including depreciation) are $10,000. She determines her deductible business expenses of $2,354.45 as follows:

1. $10,000 x 1,200/1,600 = $7,500

2. $7,500 x 2,750 business hours/8,760 total hours in year = $2,354.45

Business equipment at home: A taxpayer-employee with an employer-provided office who is not entitled to a home office deduction may still be entitled to deduct the cost of equipment used at home exclusively for work. In a recent case, the Tax Court allowed the
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

taxpayer to deduct under Sec. 179 the cost of a computer and printer used at home
where the purchase was for the convenience of the employer and required as a
condition of employment (Mulne, TC Memo. 1996-320).

ENTERTAINMENT

ENTERTAINING FOR BUSINESS

Athletes/entertainers may deduct entertainment expenses incurred in the performance of their duties.

To be deductible, entertainment expenses must be ordinary and necessary and incurred in the operation
of a business regularly carried on by the athlete. Further, they must be "directly related to" or
"associated with" the athlete's business.

ENTERTAINMENT DEFINED

Entertainment generally includes any activity engaged in for amusement or recreation.

For example: Entertainment activities can include attendance at nightclubs, restaurants, theaters, and
sporting events, as well as hunting, fishing, and vacation trips.

The furnishing of food and beverages, a hotel suite, a vacation cottage, a car, or a private airplane to
business guests may also fall within the entertainment category.

The nature of the athlete's/entertainer's business helps determine whether a particular activity is
considered to be entertainment. Thus, a hunting trip would not be entertainment to a professional
hunter, and attendance by a professional critic at a symphony concert, in the capacity as critic, would not
be entertainment to her.

In order to be deductible, entertainment expenses must be ordinary and necessary expenses incurred by
an athlete in carrying on a trade or business. In addition, the expenses must be:

- Directly related to the active conduct of a trade or business,
- Associated with the active conduct of a trade or business,
- Covered by one of the exceptions to the entertainment expense rules, or
- Adequately substantiated.

50 Percent Limitation on Entertainment Expense Deduction
The amount allowable as a deduction for business meal and entertainment expenses is limited to 50 percent of such expenses.

- For purposes of this rule, food and beverage costs incurred in the course of travel away from home are included.

- With respect to unreimbursed meal expenses incurred while traveling away from home, the two percent floor on miscellaneous itemized deductions is applied after application of the 50 percent limitation.

- As to reimbursed meal expenses, see exception (2), below. That portion of a travel meal that is "lavish and extravagant" must first be subtracted from the meal cost before the 50 percent limitation is applied.

Exceptions

Numerous exceptions apply to the application of the 50 percent limitation:

1. The cost of a meal or entertainment activity, the full value of which is taxed to the recipient as compensation, is fully deductible.

   This exception applies whether or not the recipient of the meal or entertainment is an employee.

2. Meal or entertainment expenses paid by an athletes/entertainers for which they are reimbursed (typically by their employer) are not affected by the rule.

   In such a case, the deduction of the party making the reimbursement is limited to 50 percent of the expenses.

3. Expenses for samples or promotional items made available to the general public (e.g., food samples at a supermarket or tickets to a sporting event offered as a prize to customers) are fully deductible.

4. Expenses incurred in the bona fide sale of goods or services to customers are fully deductible.

5. Expenses for certain traditional social or recreational activities that are primarily for the benefit of employees are fully deductible.

6. Food and beverage expenses associated with benefits that are excludable from the recipient's gross income as a de minimis fringe benefit are fully deductible.

7. The cost of a ticket package to a sporting event and related expenses are fully deductible if the event is organized to benefit a tax-exempt organization, all net proceeds of the event are contributed to such organization, and volunteers perform substantially all the work in carrying out the event.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

Tickets to high school or college athletic events generally are not covered by this exception because the referees, coaches, etc., are compensated.

LIMITATIONS ON ENTERTAINMENT TICKETS/SKYBOXES

The allowable deduction for the cost of a ticket for any entertainment activity or facility is limited to the face value of the ticket. The limitation is calculated prior to application of the 50 percent limitation rule (see above). This limitation will not apply to tickets for a charitable sporting event if:

1. The event was organized primarily to benefit a tax-exempt charitable organization,

2. All of the net proceeds from the event are contributed to the organization, and

3. Volunteers are utilized for substantially all of the work performed in carrying out the event.

In addition, the deduction for the rental or other use of a luxury skybox at a sports arena, if leased by the athlete for more than one event, is subject to a disallowance provision. The cost of a skybox will be disallowed to the extent that it exceeds the cost of the highest-priced nonluxury box seat tickets generally held for sale to the public for the same event, multiplied by the number of seats in the skybox. All seats in the skybox are included in the calculations, even if the skybox is not fully occupied.

- The disallowance rule does not affect the deductibility of separately stated charges for food or beverage expenses associated with the use of the skybox.

- Such expenses, as well as the cost of the skybox, are subject to the normal rules covering the deductibility of meal expenses, including the 50 percent limitation rule.

DIRECTLY RELATED ENTERTAINMENT

In order for entertainment expenses to be considered directly connected with the active conduct of an athlete's/entertainer's trade or business, the athlete/entertainer must show that:

- She had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time;

- During the period of entertainment, she was actively engaged in the active conduct of business with the person being entertained;

- The active conduct of business was the principal aspect of the combined business-entertainment activity; and
• The expenses were allocable to her and the person with whom business was conducted during the entertainment or with whom business would have been conducted had unexpected circumstances not intervened.

Clear Business Setting

Expenses for entertainment occurring in a clear business setting in furtherance of an athlete's/entertainer's trade or business will be considered directly related to the athlete's trade or business.

Examples of entertainment in a clear business setting include:

• Entertainment in a hospitality room at a convention that creates business goodwill through a display or discussion of business products and,

• Entertainment of civic and business leaders at the opening of a new hotel or theatrical production.

Entertainment Furnished as Compensation

Also considered as directly related entertainment is entertainment furnished to an individual (other than an employee) that is taxable to that individual either as compensation for services or as a prize or award. In order to deduct such costs, however, the athlete/entertainer (donee) must include the amounts on information returns filed by her.

Business Discussions

Certain types of entertainment expenses are generally considered as not meeting the "directly related" test unless the athlete/entertainer proves otherwise.

Such expenses include those for entertainment:

• at which the athlete/entertainer was not present,
• at nightclubs, theaters, sporting events, or social gatherings,
• at cocktail lounges or country clubs,
• on hunting or fishing trips, or
• aboard yachts or other pleasure boats.

Athletes may prove that these entertainment expenses were, in fact, directly related to their trade or business by demonstrating that a substantial business discussion took place during the entertainment.

Professional's Own Meal

Although someone who entertains a business client at lunch or dinner is entitled to a deduction for the cost of the client's meal, a presumption of nondeductibility arises with regard to the cost of the athlete's
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

own meal. In order to deduct the meal or avoid being taxed on the reimbursement as income, the athlete must establish that he incurred greater costs because of the business nature of the meals than he ordinarily would have sustained.

ASSOCIATED ENTERTAINMENT

Athletes/entertainers may deduct the cost of entertainment that is both associated with the active conduct of a trade or business and occurring directly before or after a bona fide and substantial business discussion. The business discussion that the entertainment precedes or follows must represent an active effort by the athlete/entertainer to obtain income or some other business benefit.

Entertainment will automatically be considered to directly precede or follow the business discussion if both the entertainment and the business discussion occur on the same day. Otherwise, the facts and circumstances of each case will have to be examined.

Among the relevant factors to be considered are:

- The place, date, and duration of the business discussion;
- Whether the athlete/entertainer or her business associates are from out of town;
- The dates of arrival and departure, if they are from out of town.

Whether a discussion is a substantial business discussion depends on the facts and circumstances of each case. The business meeting does not have to be for any specified length of time, but the discussion must be substantial in relation to the entertainment. This requirement may be satisfied by demonstrating that the principal character or aspect of the combined entertainment and business activity was the active conduct of business.

An athlete/entertainer may not deduct the cost of entertaining a spouse or the spouse of a customer unless there was a clear business purpose, rather than a personal or social purpose, for entertaining the spouse.

GOODWILL

Creating and keeping business goodwill are legitimate objectives of business entertaining. Thus, although there are restrictions on the deductibility of entertainment expenses, such expenses will not be disallowed merely because they are incurred for the purpose of generating goodwill. However, expenses in violation of public policy or conscience, disguised as "business goodwill," will not be deductible.

Entertainment expenses incurred to maintain or foster goodwill are deductible;

- If the entertainment is associated with the active conduct of business and directly precedes or follows a bona fide business discussion;
In certain limited situations involving entertainment directly related to the active conduct of a business, such as entertainment that occurs in a clear business setting.

**ENTERTAINMENT FACILITIES**

In general, no business expense or deduction is allowed for any expenses paid or incurred with respect to an entertainment, recreational, or amusement facility. However, an athlete may deduct expenses incurred for the business use of those facilities for purposes other than entertainment. If a facility is used only incidentally for entertainment, it is not considered to be an entertainment facility.

An entertainment facility is any property that an athlete owns, rents, or uses for entertainment. Examples of entertainment facilities include:

- Yacht,
- Hunting lodge,
- Fishing camp,
- Swimming pool,
- Tennis court,
- Bowling alley,
- Car,
- Airplane,
- Apartment,
- Hotel suite, or
- Home in a vacation resort.
- Clubs may be entertainment facilities.

The law stresses the identity of an entertainment facility in and of itself. Thus, deductibility is precluded for expenses such as the upkeep on a company yacht used for entertainment, although the expense of a business meal conducted for clients on a yacht is deductible. In addition, the rules apply only to facilities used in connection with entertainment. Facilities actively used in the conduct of the athlete's trade or business, facilities used by employees or the general public, and facilities for which the athlete charges
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an adequate admission are not covered, and expenses in connection with such facilities may be deductible subject to the "listed" property rules.

Club and Association Dues

Club dues or fees paid to social, athletic, or sporting clubs or organizations are no longer deductible.

BUSINESS GIFTS

A deduction is allowed for the cost of business gifts made to any person, directly or indirectly, to the extent that the value of the gift does not exceed $25 per year for each recipient. A gift to the spouse or children of an individual with whom the donor is doing business is considered a gift to that individual. However, a gift to one spouse will not be imputed to the other if there is a legitimate, separate business relationship with each spouse. On the other hand, if an athlete/entertainer and her spouse each make business gifts, both spouses are treated as one athlete/entertainer, even if each spouse has a separate business or is separately employed.

Incidental costs, such as for engraving jewelry or for gift wrapping, insurance and mailing, need not be included in determining whether the $25 limit has been exceeded, so long as substantial value has not been added to the gift.

"Business Gift" Defined

A business gift is any item excluded from the recipient's gross income under Sec. 102, and not under any other Code provision. However, the definition of a business gift does not include the following items:

- An item costing $4 or less that is one of a number of identical items that the athlete distributes generally and on which the athlete's name is clearly and permanently imprinted, e.g., pens, balloons, etc.

- Signs, display racks or other promotional material to be used by the recipient on his business premises.

These items are not subject to the $25-per-year deduction limit.

GIFT VS. ENTERTAINMENT

Generally, any item that might be considered to be either entertainment or a gift is considered entertainment. However, certain items, such as packaged food or beverages given to a customer and intended for consumption at a later date, are treated as gifts. Tickets to the theater or a sporting event
given to a customer may be treated either as a gift or as entertainment, at the option of the donor, if the donor does not accompany the customer to the performance. However, if the donor accompanies the customer to the event, the donor must consider the cost of the tickets as an entertainment expense.

CONVENTIONS AND MEETINGS

RELATIONSHIP TO TRADE OR BUSINESS

The deductibility of convention, conference, meeting, seminar, etc., expenses depends on the primary purpose of attending - business or pleasure. If there is a sufficient relationship between the athlete's/entertainer's trade or business and attendance at the convention so that she is benefiting or advancing the interests of her trade or business by attending the convention, the expenses are generally deductible. Deductible expenses may include those for travel, meals, and lodging. These are treated separately when figuring the deduction. Thus, the trip to the convention site may be primarily for personal reasons, while the expenses incurred for meals or lodging may be related primarily to business.

In determining whether a convention trip was primarily for business, the following factors must be taken into consideration:

- Amount of time devoted to business at the convention in comparison with the time devoted to recreational and social activities;
- Type of hotel chosen for the convention (i.e., resort or non-resort hotel);
- Attitude of the employer holding the convention (i.e., whether the trip is a type of award or bonus or for training purposes); and
- Employer's purpose for sponsoring the convention.

If the convention was for employees only, this indicates that it was a form of remuneration.

No deduction is allowed for expenses allocable to a foreign convention, i.e., one held outside North America, unless it is shown the convention is directly related and reasonable.

TRAVEL EXPENSES

Expenses incurred in travelling to and from an away-from-home business convention are deductible in total only where the primary purpose of the trip is business. With respect to employees for tax years beginning after 1986, if the expenses are reimbursed and the primary purpose of the trip is not business-related, such as visiting relatives or sightseeing, only expenses incurred for business-related activities are deductible.
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Combined Business - Pleasure Trip

In those cases where an athlete takes a trip within the United States that is primarily for business, and as an incident of such trip, engages in some personal activity, such as sightseeing, social visiting or entertaining, or another form of recreation, the travel expenses to and from the business destination are deductible. Such costs are not deductible if the trip is primarily personal in nature, although local transportation expenses while at the destination that are properly allocable to business are deductible.

The travel expenses of an athlete's or entertainer's spouse are deductible if the dominant purpose for the spouse's presence on the trip is a business purpose as an employee. Otherwise, the portion of the expense of the trip attributable to the spouse's travel is a nondeductible personal or living expense.

SUBSTANTIATION OF EXPENSES

SUBSTANTIATION REQUIREMENTS

Athletes and entertainers must substantiate by adequate records or by sufficient oral or written evidence deductions or credits for the following types of expenses:

- Traveling expenses, including meals and lodging, while away from home, as well as local travel expenses (i.e., cars and other vehicles);
- Entertainment expenses;
- Business gifts; and
- Computer and other "listed" property expenses

Athletes are required to answer questions on their tax returns regarding the business use of a car (or other vehicle) or other "listed" property.

Questions regarding business use of a car include:

- Total number of miles driven during the year;
- Percentage of personal use claimed;
- Whether the vehicle was used for commuting and, if so, the distance normally commuted;
- Whether the vehicle was available for personal use in off-duty hours;
- Whether another vehicle was available for personal use; and
Whether adequate records or sufficient evidence exist to justify the deduction, and whether the
evidence is written.

Employers who provide the use of a vehicle to an employee need to obtain information from the
employee sufficient to complete the employer's tax return. An employer that provides more than five
vehicles to its employees need not include any information on its return. Instead, the employer must
obtain the information from its employees, indicate on its return that it has obtained the information, and
retain the information received. Similarly, any employer that can satisfy the regulatory requirements
relating to vehicles not used for personal purposes or to vehicles not used for personal purposes other
than commuting or that treats all vehicle usage by employees as personal need not obtain information
with respect to those vehicles but must instead indicate on its return that it is exempt from these tax
return information requirements.

Questions regarding business use of other "listed" property include:

- Date that the property was placed in service;
- Percentage-of-business use; and
- Whether adequate records or sufficient evidence exist to justify the deduction, and whether the
evidence is written.

General Requirements

Athletes/entertainers must substantiate each element of an expenditure or use by adequate records or by
sufficient evidence corroborating each statement. Written evidence has more probative value than oral
evidence alone, and the value of written evidence is greater the closer in time it relates to the expenditure
or use. Although a contemporaneous record is not required, a record of the elements of an expenditure
or use made at or near the time of the expenditure or use usually constitutes the best evidence with which
to satisfy the substantiation requirements.

Adequate records include:

- Account books, diaries, and logs;
- Documentary evidence (receipts, paid bills, etc.);
- Trip sheets;
- Expense reports, and
- Written statements of witnesses.
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The requisite information must be recorded at a time when, in relation to the use or making of an expenditure, the athlete/entertainer has full present knowledge of each element of the expenditure or use.

For example: An athlete may substantiate the business use of a car for a period with a journal in which he records at the end of every week each element of the business uses of the vehicle during the week.

The level of detail required in an adequate record to establish the element of the business use of property may vary depending upon all of the facts and circumstances. Similarly, the level of detail required in an adequate record to substantiate business/investment use of "listed" property may vary depending upon the circumstances.

For example:

- An individual who uses a truck for both business and personal purposes and whose only business use of the truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording:
  - Total number of miles driven during the tax year,
  - Length of the delivery route and the date of each trip at or near the time of the trip.

Alternatively, an individual may establish the date of each trip with receipt, record of delivery, or other documentary evidence.

Documentary evidence is required for any expense incurred for lodging while traveling away from home and for any other expenditure of at least $25. An exception for transportation charges provides that documentary evidence is not required if not readily available.

Substantiation by Other Sufficient Evidence

If athletes/entertainers fail to maintain an adequate record, they must establish the prescribed elements of an expenditure or use by written or oral statement and by other corroborative evidence sufficient to establish the elements.

Athletes/entertainers may maintain an adequate record for portions of a tax year and use that record to substantiate businesses/investment use of listed property for all or a portion of the year if they can demonstrate by other evidence that the periods for which the adequate record is maintained are representative of the tax year as a whole. However, this sampling method may not be used in connection with an employer vehicle that is made available for use by more than one employee for all or a portion of the tax year.
**Loss of Records**

If athletes/entertainers can demonstrate to the IRS that the records were destroyed or lost through circumstances over which they had no control, such as destruction by fire, flood, or earthquake, the athletes/entertainers will be allowed to reconstruct their records.

**For example:**

- Under these circumstances, an athlete may be able to use records from prior or subsequent years to establish a reasonable pattern of expenses.

- Prior or subsequent years' records may not be used, however, to substantiate variable expenditure, such as mileage, lodging, or telephone expenses.

If an athlete/entertainer cannot obtain proper evidence of an expenditure under the substantiation rules because of the inherent nature of the situation in which the expenditure is made, the athlete/entertainer may prove the amount of the expenditure by other evidence (if available). However, loss of records in the course of moving between residences is not the type of casualty that will excuse failure to substantiate expenses.

**Separate Expenditure or Use**

Generally, each separate payment or use by an athlete/entertainer is considered a separate expenditure that requires substantiation.

**For example:** If an athlete entertains a business guest at dinner and thereafter at the theater, the payment for the dinner is considered one expenditure, while the payment for the theater tickets is considered a separate expenditure.

An individual may substantiate concurrent or repetitious expenses or uses, however, as a single item. Amounts expended in connection with the use of listed property, such as for gasoline or car repairs, may be aggregated. Athletes/entertainers need not prove the business purpose of each expense but may prorate the expenses based upon the total business use of the property. Similarly, an individual may consider a round-trip or an uninterrupted period of business use as a single use.

With regard to use of an employer-provided vehicle by an employee, such use may be treated as a fringe benefit to the employee where the employee uses the vehicle for personal purposes. The employer's depreciation deduction with respect to such car may be limited due to this personal use. To establish that such vehicle is not used for personal purposes in order to meet the substantiation requirements imposed on such property, an employer can prepare a written statement of its policy of no personal use of an employer-provided vehicle by an employee. Such a statement will qualify as sufficient evidence corroborating the employer's own statement.
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The following conditions must be met:

1. The vehicle must be owned or leased by the employer and be provided to one or more employees for use in the employer's trade or business;

2. When the vehicle is not being used for business purposes, it must be kept on the employer's business premises except when it is temporarily located elsewhere for repairs, etc.;

3. Under the employer's written policy, no employee may use the vehicle for personal purposes other than de minimis use, such as a stop for lunch between two business deliveries;

4. The employer must reasonably believe that no employee makes de minimis use, for any personal purpose; and

5. No employee using the vehicle lives at the employer's business premises.

If the above conditions are met, the employee need not keep records for use of the vehicle. A written policy statement adopted by a governmental unit would be eligible for this rule. To utilize the written policy statement exception, the employer must be able to supply evidence that would enable the IRS to determine whether the use of the vehicle met the five conditions listed above.

Employer-provided Vehicles: No Personal Use Except for Commuting

Another type of written policy statement that satisfies the employer's substantiation requirements is one that prohibits personal use of a vehicle by the employee except for commuting.

To qualify under this rule, the following conditions must be satisfied:

1. The vehicle must be owned or leased by the employer and be provided to one or more employees for use in connection with the employer's trade or business and be used in the employer's trade or business;

2. For bona fide noncompensatory business reasons, the employer requires the employee to commute to or from work in the vehicle;

3. The employer establishes a policy under which the employee may not use the vehicle for personal purposes, other than commuting or de minimis personal use (such as a stop for a personal errand between a business delivery and the employee's home);

4. The employer reasonably believes that, except for de minimis use, the employee does not use the vehicle for any personal purpose other than commuting; and

5. The employer accounts for the commuting use by including an appropriate amount ($1.50 per day for a one-way commute) in the employee's gross income.
The above exception does not apply to an employee who is an officer, director, or one-percent-or-greater owner of the employer. The exception also does not apply to certain high government officials. Further, for the exception to apply, there must be evidence that would enable the IRS to determine whether the use of the vehicle meets the five conditions listed above.

Once athletes/entertainers have chosen one of these written policy methods of substantiation and file a tax return for a tax year consistent with their choice, they may not later choose another method of substantiation.

**Vehicles Treated as Used Entirely for Personal Purposes**

An employer may satisfy the substantiation requirements with respect to the business use of a vehicle that is provided to an employee by including the value of the availability of the vehicle during the relevant period in the employee's income without any exclusion for a working condition fringe with respect to the vehicle and, if required, by withholding any taxes. The regulations contain an Annual Lease Value Table that may be used for valuing the use of an employer-provided car.

The employer's business/investment use of the vehicle during this period would be 100 percent. The employer's qualified business use of the vehicle would be dependent upon the relationship to the employee.

Once employers have chosen this method of substantiation and file a tax return for a year consistent with the choice, they may not later choose another method of substantiation.

**Proof of Travel Expenses**

No business expense deduction is allowed for any expenditure with respect to travel away from home unless the athlete/entertainer substantiates the amount, time, place, and business purpose of such expenditure.

The elements that must be proved are:

- Amount of each separate expenditure for traveling away from home, such as the cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

- Dates of departure and return for each trip away from home, and the number of days away from home spent on business;

- Destination or locality of travel, described by the name of the city or town, or similar designation; and
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- Business reason for the travel or nature of the business benefit derived or expected to be derived as a result of the travel.

PROOF OF ENTERTAINMENT AND MEAL EXPENSES

The elements to be proved with respect to an expenditure for entertainment are:

- Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;
- Date of the entertainment;
- Place of entertainment (name and address or location) and description of the entertainment, such as dinner or theater (if not apparent from the name of the place);
- Business purpose and nature of the business benefit expected to be reaped by the athlete/entertainer; and
- Business relationship to the athlete/entertainer of the persons entertained (name, occupation, title, etc.).

Business meal expenses of $25 ($75 for expenditures incurred on or after October 1, 1995, see IRS Notice 95-50) or more must be substantiated in the same manner as entertainment expenses. Thus, it may be necessary to prove the same elements listed above in the case of such business meals.

PROOF OF BUSINESS GIFT EXPENSES

The elements to be proved with respect to an expenditure for a business gift are:

- Cost of the gift;
- Date of the gift;
- Description of the gift;
- Business reason for the gift or the nature of the business benefits derived or expected to be derived as a result of the gift; and
- Business relationship of the recipient of the gift to the athlete/entertainer, including the recipient's name, title, and occupation.
Business gifts are generally limited to $25 per donee during any taxable year. The phrase "to promote goodwill" would probably be sufficient in most cases to serve as the statement of business purpose, since that generally is the main reason for making business gifts.

PROOF OF LISTED PROPERTY EXPENSES

The elements to be proved with respect to any listed property are:

- Amount of each separate expenditure with respect to an item of listed property;
- Amount of each business/investment use;
- Date of the expenditure or use; and
- Business purpose for an expenditure or use.

The amount of an expenditure may be the cost of acquisition (i.e., the property's basis), a lease payment, the cost of maintenance and repairs, or the cost of capital improvements. The amount of use is the ratio of business use to total use for a period of time, determined on the basis of mileage for cars and other vehicles and on the basis of time for other listed property.

Listed Property Provided to Employees

Generally, athletes/entertainers may not exclude from gross income as a working condition fringe benefit any amount of the value of the availability of listed property provided by an employer, unless they substantiate the amount of the exclusion with adequate records for the period of availability or with sufficient corroborating evidence. If the employer provides the use of a vehicle to an employee and includes the value of the availability of the vehicle in the employee's gross income without taking into account any exclusion for a working condition fringe benefit, the employee is required to substantiate with adequate records or with sufficient corroborative evidence any deduction claimed for the business use of the vehicle.

An employer substantiates its business use of listed property provided to employees by showing that either:

- Based upon adequate records maintained by the employees or upon other evidence corroborating the employees' statements, all or a portion of the use of the listed property is by employees in the employer's trade or business and that, if any employee used the property for personal purposes, the employer included an appropriate amount in the employee's income, or
- In the case of an employer-provided car, that the employer treats all use by employees as personal and includes an appropriate amount in the employees' incomes.
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For purposes of substantiating the business use of employer-provided listed property, an employer may rely on adequate records maintained by its employee or on the employee's own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that these are not accurate. Alternatively, an employer may rely on a statement submitted by an employee that provides sufficient information to allow the employer to determine the business use of the property, unless the employer knows or has reason to know that the statement is not based upon adequate records or on sufficient corroborative evidence.

REIMBURSED EXPENSES

Reimbursements and allowances received by an athlete/entertainer for travel and entertainment expenses in connection with employment must be included as income on the employee's income tax return, except where:

- Athletes/entertainers are required to and does make an accounting for such expenses to their employer;
- Athletes/entertainers do not deduct the expenses; and
- Sum of the expenses equals the total amount of the reimbursements and allowances.

Expenses in Excess of Reimbursement

In cases where athletes'/entertainers' expenses exceed reimbursements and they make an accounting to their employer, the athletes/entertainers must be able to substantiate any deduction for such excess.

Reimbursements in Excess of Expenses

In the even that the athletes'/entertainers' reimbursements exceed the amount of their expenses, the athletes/entertainers must include such excess (including amounts received for nondeductible expenses) in income.

Reimbursements Where No Accounting Required or Submitted

Athletes/entertainers who are not required to make an adequate accounting to an employer, or who are so required but fails to do so, must submit, as part of the tax return, Form 2106, Employee Business Expenses and provide the information requested on the form. In addition, athletes/entertainers must be able to substantiate any deduction for business expenses.

Allocation of Partial Reimbursement

The treatment of partial reimbursements received by athletes is dependent upon whether the reimbursement is for specified expenses and whether the employee has other business expenses. If the
employer does not indicate what expenses are being reimbursed, athletes/entertainers must allocate the partial reimbursement among travel, meals, and lodging while they are away from home.

Local transportation and other business expenses, if any, must also be allocated. This allocation is computed by multiplying the amount of the reimbursement by the percentage each expense represents to the total business expenses.

**STANDARD DAILY MEAL ALLOWANCE**

Athletes and entertainers have the option of electing a standard daily meal allowance rather than keeping records of meal expenses. However, election of the standard meal allowance does not relieve athletes/entertainers of the necessity of substantiating the time, place, and purpose of the business travel, or of the need to substantiate other travel expenses, such as lodging expenses.

*Computation*

In general, the amount of the standard daily meal allowance is multiplied by the number of days the athletes/entertainers are away from home on business. However, those days the athletes or entertainers begin or end business travel, the allowance must be prorated on the basis of six-hour periods. For each six-hour period or portion thereof that athletes/entertainers are either traveling or away from home, he is allowed one-fourth of the daily allowance. For this purpose, the day begins at midnight.

*Election*

Athletes/entertainers may elect the standard daily meal allowance merely by using it to compute the amount of away-from-home meal expenses on the return. Where the athlete/entertainer does elect to use this method, it must be used to compute all deductions for away-from-home meal expenses during the tax year except for those expenses for which they are reimbursed and which do not qualify to be computed under this method. In a subsequent tax year, the same athletes/entertainers can choose to deduct the actual cost of their meal expenses for that year, provided he can substantiate the amount of his expenses.

*Reimbursed Expenses*

In the case of athletes/entertainers who are reimbursed for meal expenses, the optional method can be elected only if:

- Athletes/entertainers are reimbursed a separate amount for meals (not a per diem allowance that provides reimbursement for both meals and lodging);
- Reimbursement is reflected as income on the athlete's/entertainer's return;
- Athlete/entertainer is not required to account for such expenses to the person providing the reimbursement; and
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- Athlete/entertainer is not related to the person providing the reimbursement.

Special Note: A "qualified performing artist" may deduct business expenses in arriving at adjusted gross income. To qualify for this deduction, an individual must:

1. Render services in the performing arts during the tax year for at least two employers,

2. Have total business deductions attributable to the performance of such services that exceed 10% of the income received from such services, and

3. Have adjusted gross income of $16,000 or less (determined prior to the application of this provision).

Employers from which an individual receives less than $200 for his services are not taken into account for purposes of meeting qualification (1) above [Sec. 62(b)(1) and (2)].

THE IRS SPECIALIZATION PROGRAM AFFECTING THE DEDUCTIBILITY OF AN ENTERTAINER'S EXPENSES

1. The IRS has a Market Segmentation Specialization Program (MSSP) for several industries. The entertainment industry Specialization Program in Los Angeles consists of one group of revenue agents (approximately 15 agents) at the IRS mid-Wilshire office, and one group of approximately 10 IRS auditors in West Los Angeles who perform office audits. Office auditors can handle about two audits per day, but revenue agents' audits can last much longer so there is time for more office audits, even though there are only 10 office auditors, as contrasted to the number of field audits that can be conducted with 15 revenue agents.

The IRS is considering joint audits with the Franchise Tax Board.

The IRS is drafting new audit guidelines for the entertainment industry, but the guidelines are not yet ready. They will be sent to practitioners as soon as they are completed.

2. Some entertainment industry audits are still being conducted out of the regular IRS offices because Los Angeles has not yet been entirely converted to the MSSP for auditing entertainment industry taxpayers.

3. The MSSP for the entertainment industry started nine years ago (it was then called the ASP) and it was then concentrating on tax shelters. The program became rather inactive after the audits of the then existing tax shelters were concluded, since the Revenue Act of 1986 reduced the number of new tax shelters that were being promoted.
4. The entertainment industry MSSP was activated again about two years ago, and the IRS converted some general revenue agents into entertainment industry specialists. The IRS still hasn't identified all of the entertainment industry compliance areas. Revenue agents are studying entertainment industry business and accounting practices.

5. Pension plans comprise an important area which the entertainment industry MSSP has not yet reviewed in detail. However, the IRS is very aware of the issue of double pension benefits—one from the guild plans and one from the entertainer's loanout company pension plan. It might possibly be advisable for clients who have funded more than one full benefit to "roll" their corporate pension plan into IRA accounts (possibly terminating the corporate plan) before the IRS starts examining this issue, since the IRS might not look at the issue and view the rollover IRA and the guild benefits together if there is no corporate plan. Many clients can have a guild plan and a loanout company plan without funding more than one maximum benefit—it is only those plans which have exceeded this maximum limitation which require planning.

6. The IRS collection department is handling payroll tax audits and these audits involve the question of whether a person is an independent contractor or an employee, which is one of the key areas that is being reviewed by the entertainment industry MSSP. The IRS collection department has taken a more aggressive position on this issue than the position taken by the revenue agents.

Several collection groups handle only employment taxes. They don't do a full audit—they review only whether you are treating people as employees or independent contractors in the manner required by law, and other issues pertaining to payroll taxes.

When California audits a tax return and determines that some people who were treated as independent contractors should have been employees, the notice from the state goes to the collections department of the IRS, and it is this department that would follow up, either by auditing the taxpayer (or, much more likely, by assessing a deficiency based on what the state assessed—a client with activities in several states would much prefer an automatic assessment based on the California audit, rather than a federal audit that would cover activities in all states).

7. There is increasing cooperation between the IRS and foreign governments on international tax audits. Foreign governments have revenue agents in the United States auditing for them, just as the U.S. has groups of IRS agents working abroad.

8. Key office audit issues include the following:

a. Verification of expenses in accordance with IRC §274. Note that the IRS is actively looking for cases where expenses are being deducted and where the same expenses have been reimbursed by the employer.

b. Allocation between expenses that are deductible against W-2 wages versus expenses that are properly deductible on Schedule C. Deductions against wages are
affected by the 2% and 3% limitations and they can cause imposition of the alternative minimum tax. It is advisable to make some reasonable allocation of expenses to the wage category, even though they may be lost under the 2% and 3% limitations, because if all expenses are put on Schedule C, this will red-flag the return for audit.

c. Expenses for massages, exercise trainers, make-up, and wardrobe, are being closely scrutinized to see if they are properly personal expenses.

d. The IRS is actively looking for people who are "non-filers." There are an estimated six million to 18 million people per year who are not filing returns and the IRS wants to bring these people into the system.

e. Determining whether the person is an employee or an independent contractor. There are 20 factors which the IRS considers in making this determination, but all 20 of the factors do not receive the same weight. By far the most important factor is who controls the person. A film producer or a director is much more likely to be found to be an independent contractor than is an actor because an actor takes instructions from the director of the film. However, when an actor is furnished through a loanout company, the IRS is inclined to recognize him as an independent contractor if he is a star of some significance because they say that, even though the contract provides that such a star is under the control of the film director, in practice an important artist may have significant input into how his role should be expressed. The IRS realizes that it is facing a long history of cases which support loanout companies for important artists and, therefore, it may well decide to limit its attack to situations where it would be less likely to be bound by prior case law. The IRS will likely not accept loanouts for athletes who are furnished to teams, and the IRS is likely to attack loanouts of "below the line" personnel (with certain limited exceptions) and artists who are loaned to a single studio on a full-time basis, as contrasted to an artist who goes from one job to another (which is more indicative of an independent contractor).

One important indicator of whether a person is an employee of his or her own loanout company (rather than an employee of the production company) is whether he or she has an employment agreement with his or her own loanout company.

Section 530 of the Revenue Act of 1978 is very important on the employee/independent contractor issue. If a company has been audited before and if the "employee/independent contractor" issue has not been raised, and if the company has a reasonable basis for the position it took, the IRS might be barred from assessing penalties. If a company changes from reporting a category of people as independent contractors to reporting them as employees, it may lose the protection of Section 530. To avoid having the IRS even assess tax (as contrasted to merely avoiding penalties), the additional requirements under IRC §3509 must be met.
Many independent contractor/employee disputes are now "stuck" in the appellate division and have been there for over a year. This appellate group is overworked and the IRS is trying to develop a consistent approach to the independent contractor/employee question. Some cases are being settled.

f. In field audits, the revenue agents will be more likely to review an entertainer's employment and loanout contracts than has been done in the past. Therefore, in preparing loanout contracts, any language that can be negotiated to show the artist is not totally under the control of the production company will be helpful. For example, it will be helpful if the artist has the right to have his suggestions considered, even though the decision of the film's director will be final. Also, if the agreement says that the production company will give instructions to the loanout company which will cause the actor to do certain things—rather than saying that the production company can give orders directly to the actor—there will be a better chance sustaining the position that the artists is not an employee of the production company.

g. The IRS is very aware of the unfairness of a production company being required to report distribution advances as income in a year prior to the time the film is completed, because amortization of the cost of the film is not yet available to offset all or part of the advance so that there will be taxable income far in excess of the real income (if any) that the film earns. The IRS will try to work out consistent positions on this, but they have not yet decided what they are going to do and therefore, unless a new rule is established, such advances should be structured as loans (or possibly, in some fact situations, as deposits) to avoid reporting them as income.

h. The IRS is aware that it is unfair to subject an entertainer's agency commission to the 2% and 3% limitations on itemized deductions since this would not be done for similar expenses in other businesses. Nevertheless they have not decided what to do about this issue.

i. The use of a tax haven company will automatically red-flag a possible audit. Therefore, when foreign corporations are being used, it would be better not to use one of the traditional tax havens—e.g., use an Irish nonresident company instead of an Antilles company, a Cayman Islands company or a Bahamas company.

j. Any transfer of assets offshore will be closely scrutinized. Therefore, if you want to use a foreign structure, there should either be a coproduction agreement pursuant to which the foreign company owns the foreign rights from the beginning, or possibly the foreign company should acquire all the rights from an unrelated party and then sell the domestic rights on shore. There should rarely be a transfer of foreign rights from a domestic company to an offshore company.

9. There is a higher audit risk for tax returns which are categorized as being in the entertainment industry, as contrasted to other industries. This results from the entertainment industry MSSP program.
DEDUCTIBLE EXPENSES OF THE PROFESSIONAL ATHLETE/ENTERTAINER

Therefore, for clients who could be categorized in either of two industries, it might be best to specify some other industry as their business category.

10. The IRS may enter into closing agreements with taxpayers where they will only assess deficiencies for one or two years but not go back as far as they could go under the statute of limitations. Under a typical closing agreement, the taxpayer will agree to abide by the new procedures (e.g., treating certain categories of people as employees rather than as independent contractors) for future years and to pay a deficiency for a couple of prior years.

THE ENTERTAINMENT INDUSTRY TASK FORCES

Task forces were formed in major metropolitan areas having connections to specific niches in entertainment. These groups have developed audit guides for MSSP auditors. Although there will be overlap, task forces in different communities are primarily responsible for creating audit guides focusing on the industry niche of their geographical location. The main groups appear to be in Los Angeles (motion pictures and TV), Nashville (music), New York (stage), and Washington, D.C. (international issues). Other groups already exist in Chicago, Ft. Lauderdale, and Cleveland, and several other districts have expressed interest in beginning similar projects.

AUDIT TECHNIQUE GUIDES

The task forces have collaborated on three Audit Technique Guides (ATGs) which cover broad areas of IRS interest in the entertainment industry. These ATGs are part of the library being created to serve MSSP auditors. The Entertainment ATGs are entitled "Entertainment: Music," "Entertainment: Foreign Athletes and Entertainers," and "Entertainment: Important 1040 Issues." These ATGs contain background information on the entertainment industry and guidelines for auditors to follow when confronted with an audit of various types of entertainment industry taxpayers. The guides may be obtained by practitioners through the Freedom of Information Act National Reading Room in Washington, D.C., for a nominal charge.
### Case Study 2-1

**Directions:**
- Spend about 5 minutes reviewing the case information.
- Discuss the solutions with the other members of your group.
- Be prepared to explain the group's solution to the others.
- Use the space provided for your notes.

**Facts:**
- Your client, Bill Rose, plays for the Minnesota Twins.
- He has submitted the following list of expenses to you.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel costs to pre-season training</td>
<td>672</td>
</tr>
<tr>
<td>Food and lodging during pre-season training</td>
<td>5,500</td>
</tr>
<tr>
<td>Reimbursement received for pre-season training expenses</td>
<td>3,510</td>
</tr>
<tr>
<td>Travel costs while on the road</td>
<td>875</td>
</tr>
<tr>
<td>Food and lodging while on the road</td>
<td>8,992</td>
</tr>
<tr>
<td>Reimbursements for road trip expenses (meal money, etc.)</td>
<td>5,110</td>
</tr>
<tr>
<td>Union dues/Players association dues</td>
<td>21,050</td>
</tr>
<tr>
<td>Telephone expenses</td>
<td>369</td>
</tr>
<tr>
<td>Postage costs</td>
<td>45</td>
</tr>
<tr>
<td>Clubhouse dues (home and road)</td>
<td>4,100</td>
</tr>
<tr>
<td>Professional publications</td>
<td>92</td>
</tr>
<tr>
<td>Agent fees</td>
<td>21,050</td>
</tr>
<tr>
<td>Trainer fees</td>
<td>150</td>
</tr>
<tr>
<td>Health club/other conditioning costs incurred</td>
<td>260</td>
</tr>
<tr>
<td>during the season</td>
<td></td>
</tr>
<tr>
<td>Publicity costs (tickets, pictures, etc.)</td>
<td>300</td>
</tr>
<tr>
<td>Uniforms/workout clothes</td>
<td>110</td>
</tr>
<tr>
<td>Laundry</td>
<td>220</td>
</tr>
<tr>
<td>Professional equipment</td>
<td>100</td>
</tr>
<tr>
<td>Other items</td>
<td>1,360</td>
</tr>
</tbody>
</table>
CASE 2-1 (Continued)

- Pre-season training - Rental car 300
- Pre-season training - Clubhouse dues 300
- Rent in Minnesota 4,000
- Golf clubs 460

Required:

- Discuss the deductibility of the expenses.

Notes:
CHAPTER 2

CASE STUDY 2-2

Your client, Bill Jones, is a professional baseball player. Bill spent two years (1996 - 1997) in the Chicago White Sox minor league system. In March 1998, he was traded to the Toronto Blue Jays. Bill spent the first two months (April and May) of the regular season with the Blue Jays AAA affiliate in Syracuse, New York. In June 1998, Bill was promoted to the major league team in Toronto and remained there for the rest of the regular season and post-season (June 1, 1998 - October 15, 1998).

Bill has approached your firm for assistance in preparing his 1998 income tax returns.

Discuss the deductibility of the rent that Bill paid in Syracuse ($1,000 a month), the deductibility of the rent Bill paid in Toronto ($1,500 a month), and other applicable deductions.

Notes:
Notes:
A predominant theme running through the tax law is the encouragement of business activity.

For example: Ordinary and necessary business expenses are generally deductible, while expenses incurred for personal reasons or for pleasure generally are not deductible.

Thus, it is essential, for federal tax purposes, to distinguish between business and personal expenses.

Tests for Deductibility:

- In order for an expense to constitute a deductible business expense, the expenses must be incurred in a trade or business carried on by the taxpayer, and the expense must be ordinary and necessary.

  Services performed by an employee (such as Bill Rose) are a trade or business, although not all expenses of employees are deductible business expenses; therefore, they may be subject to limitations.

- Although an "ordinary" expense connotes a type of expense frequently incurred by the taxpayer in a particular trade or business, an expense that is incurred only once by the taxpayer can be "ordinary" if it is considered normal for a taxpayer in a similar trade or business to incur such an expense.

- To the extent that Bill Rose has incurred the expenses in connection with his trade or business (professional baseball player), the expenses are deductible expenses.

Although many professional athletes enjoy playing golf, Mr. Rose would have a difficult time proving that golf clubs are an "ordinary and necessary" expense for a professional baseball player.
CHAPTER 2
SUGGESTED SOLUTIONS — CASE STUDY 2-2

Taxpayers may deduct travel expenses incurred while they are away from home in the conduct of a trade or business if the expenses are ordinary and necessary and not lavish or extravagant under the circumstances. Taxpayers are considered as traveling away from home if their business duties require them to be away from their tax home for longer than an ordinary day's work, and during that time, they need to rest to meet the demands of their work.

Tax Home:

■ An individual’s tax home is her regular or principal place of business, or if the taxpayer has no regular place of business, the tax home is her regular place of abode in a real and substantial sense.

■ If a taxpayer has regular work in two or more areas, the tax home is the area of the principal place of employment.

■ Factors to consider in determining the area of principal business activity are:

  Total time ordinarily spent performing duties in each area;

  • Degree of business activity in each area;

  • Relative amount of income from each area.

Temporary Vs. Indefinite Employment

■ Taxpayers who accept temporary employment away from their tax home can deduct the cost of meals and lodging at their temporary worksite.

  • Employment that is expected to last less than one year will usually be treated as temporary employment.

■ Travel expenses, including meals and lodging, are not deductible where the employment is indefinite, as opposed to temporary, in nature.

  • Employment is considered indefinite if it will not terminate within a fixed or reasonably short period, or if there is a reasonable probability, known to the taxpayer, that he may be employed for a long period of time at the new location.
A case can be made that Bill's rent in Syracuse (temporary location) can be deducted, while the rent in Toronto (indefinite location) can not be deducted.
CHAPTER 3
FINANCIAL PLANNING FOR PROFESSIONAL
ATHLETES AND ENTERTAINERS

OBJECTIVES

■ Advise clients on various financial planning techniques and investment considerations.

■ Devise a comprehensive financial plan.

INTRODUCTION

With over $1 billion in player salaries each year, there are a lot of people who want to tell athletes and entertainers what to do with their money, and, of course, earn a hefty percentage of their income for themselves. Not all of these "advisers" are honest, let alone qualified. But without federal regulations, they can all call themselves financial planners.

Formerly, only superstars had to worry about sophisticated financial planning. Now the superstars can afford to make mistakes. However, it's the average performer, whose career may be relatively short but lucrative, who is most vulnerable to a business where virtually anyone can legally hold themselves out as a financial professional.

The concept of financial planning itself seems simple: set up retirement savings programs, education funds, long-term savings programs and diversified investments, as well as cash flow budgets and tax projections. Dazzled, however, by a sudden avalanche of wealth—as short-lived as it might be—some athletes/entertainers choose to ignore long-range planning and instead fall victim to deals that promise to make them richer quicker.

Almost anyone can get conned. Even the best.

Example 3-1:

■ Wayne Gretzky once entrusted his Toronto-based agent with his fortune and saw $500,000 disappear in a failed shopping mall in Calgary, Alberta.

An out-of-court settlement was reached.
Example 3-2:

- Kareem Abdul-Jabbar put his money in his agent's hands and ended up suing his former business manager for $59 million, alleging misuse of funds.
- The suit remains in litigation.

Example 3-3:

- Jack Clark, who lost $700,000 in two real estate deals, sued five East Coast businessmen, including his agent.
  
  He was awarded over $1 million.

Example 3-4:

- Tony Dorsett became involved with so many agents that by 1985, the Internal Revenue Service took his paychecks and placed liens on two of his Dallas homes to pay $414,274 in back taxes.
  
  Also, he lost $520,000 in an oil deal, but the agent who recommended the venture eventually reimbursed Dorsett.

It appears that today's ill-prepared athlete/entertainer is faced with the question: "Who can I trust?" However, even with competent financial advisers, today's athletes and entertainers should look out for their own interests, oversee investment activities, and get independent opinions on investments.

**CPA's Role**

Athletes/entertainers often leave the financial end of their affairs to a single individual whom they trust—usually their agent. This relieves the performer of any concern or involvement, but it's also a setup that forgoes the benefits of checks and balances.

And for those who earn huge salaries and must file tax returns in every state they work in, a smooth system of checks and balances takes on extra importance.

Even if they're 100 percent satisfied with the way their agent is handling their affairs, it is wise to bring someone else in to audit their portfolio. Agents are not by any means financial counselors.

The CPA should:

- Make sure the athlete/entertainer has filed tax returns for the last three years,
- Calculate a player's/entertainer's potential liability from tax shelters and limited partnerships, and
- Get into cash management, financial planning, and budgeting for players/entertainers and their families.

Consider:

- Pro athletes and entertainers demand a different level of service than the average wealthy individual client.

  You have to work around their schedule.

  If a coach calls a practice, a player is not going to keep the appointment.

CASH MANAGEMENT

A comprehensive financial plan for a professional athlete/entertainer has as its foundation an organized approach to the management of cash. While most people are concerned with the challenging issues of applying and arranging financial resources over the long term, the athlete/entertainer should not lose sight of the fact that most of those resources begin and end as cash.

PROJECTION OF CASH FLOW

The preliminary state of an efficient cash management system is the projection of net cash flow for the next several years. These projections are intended to identify the amount of excess cash flows and deficits as well as their timing for planning purposes. Thus, it should be possible to properly plan for the use of funds in years with an excess cash flow while also minimizing the cost of raising cash in any deficit years.

Example 3-5:

- If the projection identifies a deficit in the third year, it would be wise to invest net cash flow during the preceding two years in relatively liquid and risk-free short-term investments, or

  Take measures in advance to secure adequate financing to meet the need.

- Otherwise, funds might be overcommitted to longer-term investments only to find it necessary sometime later, and possibly expensive, to liquidate assets or assume unfavorable financing.
OBJECTIVES OF CASH MANAGEMENT PROGRAM

A cash management program must satisfy the following needs:

- **First:** The program must facilitate payment of monthly living expenses and other known cash requirements.
- **Second:** The program must take into consideration the need for cash reserves in the event of an emergency.
- **Finally:** It must establish a mechanism for the efficient accumulation of excess funds before investment in long-term vehicles.

Although numerous variations on this theme are appropriate, an efficient cash management program will most likely involve the following:

- Monthly living expenses,
- Other cash requirements,
- Emergency liquidity reserve, and
- Investment reservoir.

Each of these layers should have a specific dollar limit assigned to it and be included in one or more investment accounts, as discussed below.

CASH MANAGEMENT PROGRAM

Focal points of a cash management program for a professional athlete/entertainer can be found in a money-market fund, a money-market checking account, a tax-exempt money-market fund, or some other vehicle with check-writing privileges.

Establishing and using one or more of these accounts will put temporarily idle cash to work generating at least some level of investment yield.

**Money-Market Checking Accounts**

Money-market checking accounts offer several advantages:

- Higher than "passbook" interest rates,
- Check writing,
Government-sponsored insurance on balances up to $100,000, and
- Availability through your bank or savings association.

In most cases, the use of a money-market checking account will end the need for a conventional checking account.

The only limitations of money-market checking accounts are:
- They generally require a minimum balance of $1,000 to $2,500,
- They usually have a lower yield than money-market funds, and
- They may have a lower after-tax yield than tax-exempt money-market funds for taxpayers in the higher tax brackets.

Using Investment Accounts

Athletes/entertainers should establish at least two such accounts:

1. To fund expected everyday expenses, as well as larger and less frequent cash requirements, and
2. For an emergency liquidity reserve and an investment reservoir, as discussed below.

After establishing these accounts, they must determine dollar limits for each. The living expense account should be limited to an amount to cover average monthly expenses as well as other identified large cash requirements. These larger and less frequent cash requirements might include insurance premiums, vacations, furniture, education, charitable contributions, and year-end tax payments. An additional "special use" account is appropriate for any activity requiring separate records, such as a rental real estate investment.

Cash flow in excess of these amounts should then be directed into an emergency liquidity reserve or maintained as part of an investment reservoir, or both.

It becomes even more important to observe a cash management strategy in retirement. Retirement usually signals an end to large amounts of regular, periodic earnings and the beginning of a reliance on a "fixed" amount of investable resources.
EMERGENCY LIQUIDITY RESERVE

There are several reasonable approaches for determining the amount of cash or its equivalent that should be immediately available. These involve varying degrees of personal, subjective, and technical considerations. At one extreme, the approach is entirely subjective; simply decide what amount of ready cash makes the client feel comfortable. However, a purely subjective approach may be very costly in forgone investment return.

Consequently, it is important to impose some rigor in deciding how much cash on hand is really necessary.

For example: Before committing substantial funds to a reserve, consider the availability of insurance coverages and short-term borrowing through a personal line of credit to meet needs that may be presented by emergency medical care or catastrophic damage to the client’s home. You may find that the existence of insurance and the immediate availability of prearranged credit totally eliminate the need for cash reserves for these purposes.

One emergency in which liquid resources may be especially necessary is the athlete's/entertainer's sudden retirement or injury.

Therefore, while the probability of job loss may be low, its effect on short-term financial well-being can be severe. Some emergency liquidity reserve may be appropriate for this purpose. However, some discipline is necessary in determining the limit of this reserve. The well-worn standard of six months' income is a good place to start, but it is only a start, since six months' compensation carries with it substantial tax liabilities and may also carry what would otherwise be substantial net investable cash flow. Therefore, that standard should be discounted to the amount necessary to cover six months' living expenses. An amount equal to three or four months of gross compensation should be the upper limit necessary to permit a comfortable assessment of new employment opportunities and the market conditions affecting your longer-term investments.

Even this limit can be lowered substantially if the athlete's/entertainer's longer-term investments are capable of ready liquidation. A very low-volatility stock or bond portfolio, combined with an investment reservoir, may totally eliminate the need to set aside funds for emergency purposes.

INVESTMENT RESERVOIR

After the athlete/entertainer has paid all living expenses and funded a satisfactory emergency reserve, any additional cash flow will be available for funding longer-term investments. While awaiting deployment to such investments, these funds should be "parked" in a liquid source such as a money-market fund in order to maximize the total after-tax return.
Historically, more substantial investment returns have accrued to longer-term investments than to short-term ones. Also, historically, longer-term investments have required greater amounts of capital commitment than have short-term opportunities. Consequently, successful investors have generally developed an approach that accumulates resources in short-term opportunities for eventual commitment to longer-term investments. In recent years, the relative strength of long-term investment returns has weakened in comparison with that of short- or medium-term returns. Moreover, investment vehicles such as mutual funds and limited partnerships now reduce the dollar-amount thresholds for access to long-term investments.

Nevertheless, there remains considerable value in maintaining an investment reservoir as a matter of logistical convenience. In this vein, two important considerations will determine the funding of and disbursement from their reservoir.

First: Determine the most readily available sources of funding and commit those sources to the investment reservoir immediately upon receipt.

Example 3-6:
- If a client projects net cash flow of $200,000 for the entire year and a $350,000 bonus payment to be received in January, $200,000 of that bonus payment should be viewed as immediately investable and captured accordingly.

Second: Place a trigger point or amount on the fund.

This will minimize the risk that funds may be left relatively idle too long. It will also ensure that significant investment commitments are not made too often and with relatively small amounts.

- Consequently, if net cash flow is relatively large, you might establish a time trigger point of, for example, the end of each calendar quarter.

- If it is relatively small, you might establish an amount trigger of, for instance, $10,000 or $20,000, even if it takes quite a bit longer than three months to accumulate such an amount.
INVESTMENTS

DEFINING OBJECTIVES

All investments involve the commitment of current funds with the expectation of deriving future income. In other words, to invest is to defer current gratification in exchange for future reward. Why forgo current gratification? Why invest?

While the immediate response may be "To increase wealth," it is much more meaningful for planning purposes to define specific objectives.

For example:

- To assure the client's ability to fund a major future expenditure, such as their children's education.
- To augment resources available in retirement to avoid a drastic reduction in life-style in later years.
- To improve the survivor's financial circumstances in the event of early death.

A quite different goal might be to accumulate sufficient funds to be in a position of financial independence apart from current employment.

This is not intended to be a complete listing of possible objectives, nor is it a casual one. Quite different investment strategies can flow from even this small number of objectives. The point is that once the specific reasons for investing are identified, the importance of meeting those objectives (as well as the "cost" of failing to meet them) becomes apparent. Moreover, the appropriate choices among all possible investment opportunities come into focus.

ESTABLISHING PRIORITIES

Having identified objectives, one should next list them in order of importance. To do this, it is important to evaluate the tolerance of risk in accomplishing each object. Generally, the level of investment return is directly related to the degree of risk accepted.

To establish the risk criteria, first consider the general level of return required to achieve the objectives. The CPA should also attempt to satisfy each objective while accepting the least possible degree of risk. The key is to layer the investment program in accordance with the objectives.
Thus, one investor may pursue crucial objectives at low risk (low return) and, in so doing, foreclose the opportunity to achieve other, less important objectives that require high return (high risk).

Another investor may pursue ambitious objectives with high return (high risk) investment and, in so doing, diminish the likelihood of achieving other, less ambitious objectives that could be achieved at low risk (low return).

**INVESTMENT CONSIDERATIONS**

Before selecting the instruments needed to implement an investment strategy, it is important to understand the relationships between the crucial investment factors of return, risk, and time.

**RETURN**

Return is the level of earnings arising from an investment. The earnings may be current income, capital appreciation, or both. After-tax rates of return, or after-tax yields, should be used to ease comparisons among investment alternatives, since different investment vehicles are often afforded differing tax treatment.

**Example 3-7:**

- The interest from a municipal bond is generally exempt from federal taxation and may be exempt from state taxation as well (dual exempt).

  This means that the coupon rate of a dual-exempt municipal bond purchased at par (face value) accurately reflects its after-tax return.

  However, interest from a corporate bond or a dividend from common stock is generally taxed by both federal and state governments.
TAXABLE EQUIVALENT YIELDS

The following table shows the taxable equivalent yields for tax exempt products at various interest rate levels.

<table>
<thead>
<tr>
<th>Federal Tax Rate:</th>
<th>28.0%</th>
<th>31.0%</th>
<th>36.0%</th>
<th>39.6%</th>
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</thead>
<tbody>
<tr>
<td>Tax-Exempt Yield</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.00%</td>
<td>2.78%</td>
<td>2.90%</td>
<td>3.13%</td>
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<td>2.25%</td>
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<td>9.72%</td>
<td>10.15%</td>
<td>10.94%</td>
<td>11.59%</td>
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</table>

RISK

Risk is the level of uncertainty related to an investment. Several kinds of risk are present in any investment. One is the variation in the real growth rate in the economy. Also there is inflation and the variation in its rates, which contributes to uncertainty about the future purchasing power of investment returns. When a specific level of income is not guaranteed at purchase, the level of risk may rise or drop during the period the instrument is held. Even if the income is guaranteed, its risk level compared with that of other instruments may vary over the holding period. Finally, when the decision is made to sell
the instrument during or at the end of the planned investment period, its market value may have risen or fallen, or there may be only a limited number of purchasers interested in that particular investment.

**TIME HORIZON**

Selecting investments with the appropriate relationship between risk and return involves more than knowing the importance of the goal; the client must factor in how much time is needed to permit the investment returns to occur. A crucial goal with a short time horizon, such as funding a teenager's college education, requires a low-risk portfolio, perhaps very different from one designed to fund a crucial long-term goal, such as comfortable retirement.

Consider:

- Analysis of the relationship between time horizon and degree of risk confirms the common wisdom that in the short term the volatility of common stocks compared with that of maturity-matched debt instruments makes the stock market riskier than corporate or government bonds.

- Although it is possible for the stock market to substantially outperform fixed-income investments in a short period of time, the risk is that the market will do worse, perhaps much worse, producing a substantial loss.

**LIQUIDITY AND MARKETABILITY**

Marketability and liquidity are sometimes confused. Liquid assets are those which can easily be converted to cash without significant financial loss. Marketability is determined by the speed and ease with which an investment may be bought and sold. Liquid assets are readily "marketable" and generally include short-term government securities, money market funds, savings accounts, and certificates of deposit.

CPAs should evaluate the degree of liquidity clients actually require. Some investors may not need to liquify their portfolios because other assets or credit lines are available; others may require a large degree of liquidity only after a certain date, such as retirement.

**DIVERSIFICATION**

Within any general investment category such as common stocks or bonds, diversification will reduce unsystematic risk (risk associated with one particular stock or other investment).
Diversification within any general investment category will not prevent the fluctuations in value caused by factors that affect the category as a whole (systematic risk). Consequently, allocating a portfolio among investment categories can reduce systematic risk.

**Example 3-8:**

- The systematic risk associated with holdings only in the stock market can be reduced by shifting portions of the investments to other categories, such as bonds, money market investments, or even other economies by investing in foreign securities.

**Consider:**

- Diversification into other economies may lead to a better portfolio performance or to a decrease in portfolio risk.
  
  - By committing funds to foreign investment, it is possible to take advantage of opportunities not available in the United States or to balance cycles of domestic investment performance.

- Diversification will decrease the amount of downside risk of the portfolio.
  
  However, it can limit the probable upside gains of the portfolio as well.

- Consequently, layering the portfolio according to objectives is also relevant in this context.

- Although it is sometimes advisable to take a deliberately undiversified posture in investments aimed toward the clients' "most ambitious/least crucial" objectives, diversification may be essential to increase the safety of investments aimed at achieving the clients' most crucial goals.

**MANAGEMENT EFFORT**

Be realistic about how much time clients can devote to the active management of their investments. However, try to get your clients as involved as possible.

Communicate all investment information regularly. Document all communication. Don't delay negative results; these are often more important to communicate and document.
Example 3-9:

- If the family or employment responsibilities make substantial and unpredictable demands on an entertainer's time, she should select an investment strategy that requires less continuing care and review.

  She could select mutual funds and choose an investment manager.

- She may segregate a relatively small and currently discretionary portion of the total portfolio for direct attention as a "hobby," which broadens into active, overall management after her retirement.

TRADING COSTS

In addition to the time and effort, most investment transactions require some brokerage commissions and fees and may cause income and other taxes to be levied. If a regular "churning" of the client's portfolio is substantial, transactions can benefit from what are, in effect, volume discounts. In contrast, an investment program involving relatively small annual increments is better served by avoiding transaction costs as much as possible.

ALLOCATING ASSETS AMONG INVESTMENT CLASSES

If only one fixed-income investment opportunity were available, personal financial decisions would be fairly simple. However, given the enormous number and the sophisticated range of investment opportunities, the placement of investable assets becomes highly complex.

In any investment analysis, it is important to make two sets of distinctions.

1. Consider both the market environment (what investments are "possible") and the investor environment (what investments are required).

2. Distinguish between analyses of individual instruments and analyses of groups of instruments functioning as a portfolio.

Layering may again be appropriate.

After establishing the objectives and risk and return levels, the strategy for each layer of the portfolio can be determined. The appropriate investments to fit these strategies can also be chosen now. Among the types of investment vehicles to consider in structuring a portfolio are common stocks, taxable fixed-income securities, tax-exempt investments, real estate, precious metals and gems, and other miscellaneous investment vehicles.
PURCHASING INVESTMENT

Once the types of instruments have been decided and what proportions of the total portfolio will be allocated to each type, the methods of purchase (choosing brokers, etc.) can be selected.

BROKERS

For many athletes/entertainers, the selection of a broker (as well as possibly an investment or money manager) is one of the most important investment decisions. Before selecting one, it must first be decided what services are needed. An investor who does not usually need much advice may wish to use a discount broker who provides a limited variety of services at a discounted commission rate. For those investors who need more assistance in making investment decisions, a full service broker would be more appropriate. When selecting such a broker, shop around for the one who can offer the services needed at the lowest cost.

Depending on the size and composition of the portfolio, you may need to develop relationships with several brokers. For example, a discount stockbroker does not ordinarily handle real estate partnerships; a bank's investment department may handle only municipal bonds. As a rule, brokers are compensated in relation to the size of your transaction; if the transaction is big enough, you may be able to negotiate a fee that is quite favorable but still provides the brokerage a reasonable profit.

TAX-DEFERRED ACCOUNTS

Although most team sports and entertainment industry unions have collectively bargained plans, the use of tax-deferred accounts, such as 401(k) plans, Keoghs, and individual retirement accounts (IRAs), should be an important investment consideration. The earnings inside these accounts are not taxed until withdrawn, enabling the funds to be fully reinvested and grow within the account. Because of this tax-deferred growth, it is usually wise to fund the maximum amount allowed in these types of accounts as a first step in allocating investment assets.

TAXABLE FIXED-INCOME SECURITIES

Some portion of the return of a fixed-income security is known with relative certainty when the investment is made. This portion of the return is in the form of a coupon, an interest rate, or a stated dividend. The uncertainty surrounding these returns is whether they will be paid, not the amount that will be paid. As the uncertainty of payment rises, investors will demand higher levels of return in exchange for assuming the higher risk that it might not materialize.
CHAPTER 3

MUTUAL FUNDS

Mutual funds offer the advantage of placing even very small portfolios in the hands of professional managers.

One potentially serious disadvantage of mutual funds is the effect of the unrealized gains that are within the fund at the time of purchase. Some of these gains will be realized during a normal year since managers trade in order to eliminate stocks that no longer meet their criteria, and they are sometimes forced to sell to meet daily redemption requests.

One of the advantages of mutual funds is convenience. Investment in mutual funds may be made on a regular (e.g., monthly) basis and in small dollar amounts.

Many funds provide the option of automatic reinvestment of income and capital gains. And since each mutual fund generally has a specific investment orientation, such as current income or capital appreciation, it is possible to find funds that meet the client’s own array of investment objectives and criteria. Mutual funds also provide accurate and convenient records of holdings and tax obligations.

The fund’s risk/return evaluation is a difficult step. Starting from the premise that the S&P 500 represents the stock market, you can evaluate the philosophy and history of a fund in relation to the S&P 500.

Since the S&P 500 can, in effect, be purchased through a no-load index fund with very low management fees, the reason to buy other stock funds with higher management fees is that they may provide the opportunity to get added value: better price performance, more (or less) currently taxable income, less volatility, or lessened exposure in down markets.

TIMING

The final step in the purchase process is to decide on timing. If available funds to invest have been identified, they can be invested over a relatively short period of time. More likely, there is an investment portfolio already in place, in which case adjustments may need to be made over a longer period of time. Some adjustments can be made immediately, such as committing current cash to some other investment vehicle. Finally, the portfolio must be continually evaluated and further purchase and sale decisions made.

DEBT MANAGEMENT

Debt is one of the most common elements in any consideration of personal financial planning. It is also, typically, one of the most poorly managed.
Debt, such as a home mortgage or consumer credit, may be a matter of practical necessity or convenience, particularly in the early stages of a client's career. In this context, the general rules of good management are relatively simple: shop for the lowest interest rate available, and do not borrow more than the cash flow will allow you to repay on time. Self-interest and that of the lender should combine to make sure that these rules are followed. However, given recent innovation in financing arrangements, particularly for residential real estate, it can be a little difficult to know where self-interest lies.

Debt may also be a matter of opportunity, particularly in more advanced stages of a career. The best examples are leveraged investments, such as real estate or a margined securities account. Here the rules take on additional meaning. The opportunities and constraints associated with discretionary debt should be a primary focus of financial planning. This section focuses especially on these issues.

**CONSUMER CREDIT**

The use of consumer credit, whether through credit cards or loans, has never been more prominent in the spending habits of most consumers. Very few services or products cannot be obtained under the "buy now, pay later" arrangement. While the use of consumer credit can play a positive role in financial planning, the temptations for misuse and abuse have never been greater. It is very important to be aware of the cost of consumer credit, how to control it, and how to use it wisely.

**BENEFITS AND COSTS OF INVESTMENT LEVERAGE**

One of the most difficult aspects of good financial planning is the effective use of investment leverage - financing a portion of the purchase price of an investment with borrowed money. The higher the percentage of funds borrowed, the higher the leverage position; with high leverage comes greater potential opportunity and greater risk.

Contrary to popular misconception, how clients finance an investment, whether exclusively with their own cash or with a combination of cash and borrowed funds, cannot affect the absolute performance of that investment. The pretax return on a $10,000 Treasury investment paying 10% interest will be $1,000 regardless of how clients financed the purchase. What is affected by the manner in which clients finance an investment is the return on equity, the personal funds that one commits to that investment. Through proper investment leverage, clients may be able to realize a rate of return on their equity greater than the nominal rate of return offered by the investment.
CHAPTER 3

REDUCING EXISTING DEBT AS INVESTMENT ALTERNATIVE

At times, the reduction of leverage may present a better opportunity than the expansion of debt. Repaying indebtedness is an investment alternative that should compare with other investment opportunities.

The return on debt payment as an investment is the elimination of the after-tax interest cost. Those after-tax costs can be very substantial. Consequently, the after-tax returns from repayment can compare very favorably with after-tax returns available on other investments.

INSURANCE

The purpose of this section is to analyze the role of insurance in financial planning. Insurance comes in many forms: life, disability, health, homeowner's, automobile, and various property and liability coverages.

For the specific provisions of any group life, disability, and health insurance made available to players under their league's plan and performing and creative artists under their union or guild plan, refer specifically to the benefits manual. This discussion will limit itself to those coverages for which the performer's decision is crucial. Thus, the following comments will be divided into broad categories: personal life insurance, annuities, individual disability insurance.

LIFE INSURANCE — HOW MUCH IS ENOUGH?

Life insurance is unique among all forms of insurance in that it relates to an eventuality about which there is no "risk": death is a certainty. Rather, the risk is the occurrence of death at a time when financial resources are otherwise not adequate to achieve the objectives.

Since the actual time of death is unpredictable, there must be planning for needs that currently exist. Nevertheless, realize that, as time goes on, currently relevant goals may cease and currently inadequate resources may be cured by various forms of wealth accumulation or the passage of time. Therefore, the exposure, once initially determined, may eventually no longer be present. This recognition is crucial in determining the appropriate form and duration of insurance coverage, if any, to acquire.

IDENTIFYING AND COMPARING AVAILABLE RESOURCES

The next step in estimating insurance needs is to quantify available capital assets and sources of income over time from:

- Pension/survivor benefits,
FINANCIAL PLANNING FOR PROFESSIONAL ATHLETES AND ENTERTAINERS

- Earnings (from the surviving spouse and other family members),
- Social Security (now or in the future), and
- Capital assets (investment portfolio, real property, etc.).

Some income streams may be adjusted for inflation (Social Security, for example), and this must be taken into account. Capital assets would provide both income and principal to cover needs.

These streams of income, and projected outlays of principal from capital assets, must be compared on an after-tax basis with the previously established expenditure objectives. In making this comparison, the amount of insurance required by transforming any future dollar shortfalls into a present dollar lump-sum amount would be determined. The amount of insurance is the lump sum that, if invested now at a reasonable rate of return, would cover the identified shortfalls by paying out both interest and principal over the required period.

Since it is likely that survivors will rely, at least to some extent, on an invasion of capital resources, the ultimate question becomes how much capital is necessary.

- If the clients determine that capital resources are inadequate to meet current goals, they will need either additional life insurance coverage or a change of goals.
- At the other extreme, if it is determined that current identifiable capital resources are more than sufficient to meet the goals, some or all of the existing insurance may be canceled.
- In the middle ground, the analysis of survivors' financial circumstances may simply indicate the appropriate nature and direction of a general investment program.

Financial Security for Survivors

Throughout this process, it is important to assess the realistic limits of being able to assure the financial security of the survivors.

- If the client is financially well established, having accumulated a substantial amount of assets during a career, he may not have a problem in providing lifetime financial security for the spouse and children.
- However, if the client is a younger performer just beginning a career, it may be difficult, if not impossible, to provide lifetime financial security for the spouse and children, even with the purchase of substantial additional insurance.

If this is the case, one should consider the following alternatives and discuss them with the client's family:
Could the family live comfortably in a more modest residence?

Can the children be expected to fund, through loans or part-time earnings, a greater portion of their education?

Could the spouse work?

Clearly, none of these questions is easy to raise with loved ones, much less to answer. But a "yes" answer to any one could substantially reduce the amount of assets necessary to ensure the family's lifetime security.

**Types of Life Insurance**

*"Pure" Death Coverage (Term Insurance)*

This type of policy, known as term insurance, is simply one year of coverage on the client's life. It is priced according to the risk of death during that year. The cost - the premium - is the total of the company's expenses and expected profit plus the "mortality charge" for people of the insured's age and health status. "Convertible" term insurance may also be beneficial.

*Whole Life Insurance*

Also known as traditional or straight life insurance, the whole life insurance policy is written for an amount of insurance protection payable upon death or at a certain age, generally age 95 or 100. A level premium is paid over the entire life span. Premium payments purchase risk protection and build a cash reserve. Since the face amount of the policy is fixed and the cash value is increasing during the period the policy is in force, the amount of pure risk protection correspondingly decreases. Thus, a whole life insurance plan could be viewed as a combination of decreasing life insurance and increasing investment fund.

*Variable Life Insurance*

The variable life insurance policy is similar to traditional whole life because it has guaranteed premiums and a guaranteed minimum death benefit. It differs in that the death benefit may increase or decrease, but never below the guaranteed minimum of the policy's face amount. The insured must choose how the cash reserves are to be invested. The amount by which the death benefit may exceed the minimum depends then on the returns of the investment options that the insurer offers and the insured selects. Since the cash reserve can rise or fall with the market, the death benefit can rise or fall to the guaranteed floor. By having policyholders choose how they want their cash value invested (typically, from among several funds), the insurer is causing them to accept some of the investment risk. Buying variable life
insurance is an investment decision. Consequently, the investment management ability of the insurance company, or its affiliates, becomes important in the selection process.

**Universal Life Insurance**

The universal life insurance policy often looks much like the whole life policy, but it is designed to allow more flexibility. The death benefit can be increased or decreased, depending on the amount of the premium that one chooses to pay. In any event, the deposits are high enough to create a cash reserve that helps offset ever-increasing mortality costs, while also building cash value, which is available during life and at death. Government regulations limit how big the "savings account" can be in relation to the death benefit.

**INDIVIDUAL DISABILITY INSURANCE**

Disability income protection is designed to replace lost income if clients cannot work because of illness or injury. A variety of programs are available for this coverage, including worker's compensation, Social Security, state disability programs, disability coverage on life insurance policies, and miscellaneous federal plans. For specific provisions of the group disability and health insurance available to clients under employer or team plans, refer to the benefits manual. This discussion will focus on individual disability insurance and protection against income lost during disability periods.

**Individual Disability Income Insurance**

Despite the importance and growth of group disability income insurance, individual policies may remain an important means by which performers can further protect against disability risk. Individual policies provide weekly or monthly benefits for a specified period (maximum benefit period) during the duration of total, or sometimes partial, disability. Individual disability income insurance should be analyzed mainly in terms of perils covered, maximum benefit period, definition of disability, elimination period, and amount of coverage. In addition, the renewal or continuance provision should also be reviewed.

**PROPERTY AND LIABILITY INSURANCE**

Financial planning involves not only building economic wealth, but also protecting against unforeseen events that could jeopardize the client's current position. This section briefly discusses areas for which insurance protection can be obtained to guard against such risks.

**Homeowner's Insurance**

This type of insurance is designed to protect the clients from liability arising from occurrences on their premises and from the risk of property loss due to a variety of perils, such as fire, storm or theft.
To assess the adequacy of the basic policy limits, the relevant figure is not the fair market value of the residential property.

Rather, the appropriate figure is the replacement cost of the building structure involved.

To benefit from the full coverage specified in a policy, the insured amounts generally must be at least a certain percentage of the replacement cost.

**Personal Property Insurance**

The basic policy also offers protection against the loss of personal property items. Generally, the policy will insure personal property for its actual cash value, which is defined as replacement cost less depreciation, up to the amount of the policy limits.

**Important:** One should take special note of the sublimits that may exist. For instance, many policies limit the recovery on the loss of cash to $100, and on jewelry and furs to $1,000, after deductibles. Other sublimits may apply to securities, stamp collections, watercraft, silverware, and guns. Therefore, to protect against loss on these items, clients may wish to obtain a personal articles floater, which, for an additional premium, would protect against losses in excess of these sublimits.

**Personal Liability Insurance**

The risk of loss of financial assets is not limited to the physical destruction of these assets. A potentially greater risk is the loss of assets or earnings through the judicial process as a result of negligence.

Homeowners' policies generally contain personal liability provisions stipulating that if someone is injured in an accident on the property, or in an accident (except an automobile accident) away from the property but caused by a member of the family, one is covered for damages up to the limits of the policy. Under this provision, the insurance company will pay the legal cost of defense and damages assessed, up to the policy's limits.

Liability coverage provided by homeowners' policies is often as low as $25,000 per accident. Since purchasing additional liability insurance is inexpensive, select the maximum allowed, but not in excess of the minimum coverage required by an "umbrella policy."

**ANNUITIES**

Annuities are the cousin of life insurance policies. In the annuity contract, the insurer agrees to make payments to the client as long as the client or a survivor lives, sometimes for a fixed minimum number of years.
Clients may purchase annuity contracts with a single premium or with a series of annual premiums over an agreed period. If the clients purchase an annuity contract with a single premium, they may choose immediate annual, quarterly, or monthly payouts or defer payouts to a time of their choosing. If they purchase an annuity contract with a series of annual premiums, payouts should be deferred, at least until all of the annual premiums have been paid in.

**TYPES OF ANNUITIES**

Annuities can be either fixed or variable. When one purchases a fixed annuity, the contract will specify an interest rate, which is guaranteed for a certain period of time. After that, the rate will change periodically, although there are guaranteed minimum rates. The insurance company invests the funds generally as it would for whole or universal life insurance, although the return on annuities is usually somewhat higher.

A variable annuity is similar to variable life insurance in that the purchaser has a choice of investment vehicles including common stock funds and must bear an investment risk. The company's investment management record is a key factor in selecting a variable annuity contract.

Some annuity contracts combine a fixed account with a variable account and permit shifting funds periodically between accounts, as well as among the investment opinion in the variable account.

**EMPLOYMENT BENEFITS**

**QUALIFIED PLANS**

Most athletes and entertainers have the opportunity to participate in some form of qualified retirement plan, typically a pension, profit-sharing, or savings plan. Generally, a plan will be qualified if it provides for participation in a nondiscriminatory manner. To maintain a qualified status, a retirement plan must comply with certain restrictions.

The restrictions that apply to qualified retirement plans are principally in the form of limitations regarding employer and employee contributions, as well as limitations regarding distributions from such plans. Different limitations apply, depending on whether a plan is a defined contribution plan or a defined benefit plan.

A defined contribution plan (e.g., a profit-sharing plan) is a plan in which contributions are made as a percentage of compensation or an athlete's/entertainer's earnings or profits. The size of the benefit ultimately available will depend on the level of the contributions and the earnings on these conditions. A defined benefit plan (e.g., a pension plan) is a plan in which the amount of a participant's benefit is predetermined and then funded by contributions and earnings along the way.
Defined Contribution Plans

Under a defined contribution plan, contributions (by both employer and employee) may not exceed the lesser of 25% of an employee’s annual compensation or $30,000. The maximum pretax contribution that an employee is permitted to make to a 401(k) plan (a defined contribution plan named after the Internal Revenue Code section that authorized it) is limited. (In some circumstances, however, it may not be possible to contribute even this entire amount because of the plan's failure to pass a complicated set of percentage limitations.)

Defined Benefit Plans

Under a defined benefit plan, the annual benefit attributable to employer contributions that can be paid to an athlete/entertainer is limited. This amount is indexed for inflation.

The limit of the annual benefit under a defined benefit plan is actuarially reduced if the benefit begins before the normal retirement age under the Social Security Act. The normal retirement age is determined by the age at which an athlete/entertainer can first receive the primary insurance amount under the Social Security Act, as subsequently discussed. The Tax Reform Act of 1986 includes a "grandfather" provision preserving larger benefit entitlements accrued as of December 31, 1986, if the defined benefit plan was in effect and the client was a participant on May 6, 1986.

Retirement Plans

Since most retirement or pension plans are noncontributory, clients are typically not required to make decisions regarding them until retirement approaches. At that time, the principal consideration is to select a distribution option in the form of either an annuity, or if available under the terms of the plan, a lump sum.

The most appropriate distribution option will be determined by a consideration of the following factors:

- Age and health of the participant and spouse,
- Other sources of postretirement income,
- Postretirement living expense requirements,
- The availability of investable capital to supplement postretirement income, and
- The general economic environment.

Individual Retirement Accounts

If the athlete/entertainer or the spouse is an employee or self-employed with earned income, an individual retirement account can be established as a private, tax-favored capital accumulation plan. If
the athletes/entertainers qualify, they may each contribute up to the lesser of $2,000 or 100% of employment earnings annually into an IRA and possibly claim a deduction for that amount in determining their adjusted gross income. Another alternative is the backloaded Roth IRA, discussed in the 1998 Tax Changes section, above.

Receipt of alimony will qualify as earnings for purposes of establishing and funding an IRA. In the case of a nonworking spouse or a spouse with a minimal amount of income, the employed (or self-employed) spouse may open an IRA for the nonworking spouse and make contributions to the two accounts of up to $2,250 in total annually. In funding such "spousal" IRAs, they may divide the amount in any manner they choose, as long as the amount contributed each year to either IRA is not more than $2,000. IRAs have been limited if the athlete/entertainer is covered by a qualified employer plan.

Keogh (HR-10) Plans

If the athletes/entertainers are self-employed, they are entitled to establish a form of private, tax-favored plan known as a Keogh plan.

These are the important differences between a Keogh plan and an IRA:

- Athletes/entertainers are eligible to establish a Keogh plan even if they are covered by a qualified plan or have an IRA, or both, but only self-employment earnings, such as outside director's fees, net of related expenses, are included in the Keogh plan contribution base.

- The maximum contribution for a profit-sharing Keogh plan is equal to the lesser of $30,000 or 15% of net self-employment income.

  - This percentage limitation may be increased to 25% by using a money purchase pension plan or a combination of both types of plans.

- Net self-employment income is reduced by 50% of the self-employment tax, as well as by the amount of the Keogh contribution itself.

Retirement planning for performing and creative artists shares many elements common to retirement planning for other high-income taxpayers. The general strategy for most high-income taxpayers is to defer as much money as possible from current income taxation through the use of qualified retirement plans. The foregoing generality, however, may not apply to all performing and creative artists. There are unique aspects of retirement planning for artists. For example, the use of a corporate retirement plan is one of the attractions in deciding to form a loanout corporation; should the planning strategy not include the use of a corporate retirement plan, the use of a loanout corporation would not be as attractive. If a corporate plan is part of the planning strategy, the career and financial circumstances of the artist might affect the type of retirement plan adopted for the loanout corporation. Similarly, these circumstances could influence the investment philosophy for the assets in any qualified plan directed by the participant (e.g., an IRA or loanout corporation plan). Also, since there is a possibility that contributions may be made to both industry guild plans and loanout corporation plans during the same
income tax year, the IRS position on such arrangements could affect retirement planning. Recently, the view taken by the industry guilds on this subject has also become relevant information to include in a retirement plan analysis. Even the legal, accounting, and actuarial costs of plan administration may need to be considered in determining a strategy.

**NONQUALIFIED PLANS**

Most athletes/entertainers are not eligible to participate in nonqualified plans. However, participation in such plans may become more prevalent in the future because of the increasingly restrictive nature of the tax laws regarding qualified plans.

*Deferred Compensation Plans*

A nonqualified deferred compensation plan typically provides the opportunity to postpone income tax on compensation income by permitting the participant to defer salary, bonuses, or other types of cash incentive payments. To avoid "constructive receipt," the participant must make an irrevocable election beforehand to defer the payment. This means that the election must be made before the period in which the compensation is earned.

A deferred compensation plan offers these advantages:

- Both the amounts deferred and any earnings thereon may be accumulated tax-free to the participant until the eventual distribution occurs.

- The opportunity to defer compensation payments on a pretax basis can provide a large source of funds to invest over the period of accumulation, resulting in an increased level of effective earnings.

- Thus, the participant is generally able to enjoy a higher effective after-tax rate than would be available at a similar level of risk.

However, there are disadvantages:

- A lack of liquidity is associated with deferred compensation plans, since deferred amounts are generally inaccessible until the distribution date provided under the plan. The client may need the money.

- Deferred amounts usually are in the form of unfunded liabilities, placing participants in the position of being general creditors of their employer.
Although some deferred compensation plans are funded under trust arrangements structured to avoid the constructive receipt rule, this will only protect participants from a change in management sentiment and not from the employer's insolvency.

- Deferred amounts are subject to Social Security withholding tax at the time of deferral, although this may be of little relevance if the participant's other compensation will exceed the maximum wage base.

- Possible increases in future income tax rates could adversely affect the eventual benefit.

- Deferred amounts could reduce the participant's eventual pension or other qualified plan benefits in situations where the pension formula or contribution base relies on current W-2 compensation, thereby excluding deferred amounts.

Federal Income Tax Considerations

The tax treatment of nonqualified plans is dramatically different from that of qualified plans - both better and worse. On the one hand, the opportunity to use special averaging calculations or IRA rollover treatment is not available. On the other hand, there are no additional taxes attributable to early or excess distributions from a nonqualified plan. Rather, distributions from nonqualified plans are merely taxed as ordinary income, in most instances, when received.

ESTATE PLANNING

Estate planning is the process of establishing the game plan - for caring for the athletes/entertainers and their loved ones and for managing, administering, and distributing assets - in the event of incapacitation or death.

ESTATE PLANNING OBJECTIVES

As with other areas of financial planning, the first step in making an estate plan is to establish the objectives. There are a number of financial and tax objectives involved in estate planning. However, two overriding concepts should be the starting place for all other planning:

1. The optimal disposition and management of assets that will pass at death; and

2. The minimization of confusion and emotional strain on the beneficiaries of the assets.

Once the objectives in these areas have been established, advisors can assist in accomplishing these goals at minimal cost in taxes and other expenses.
CHAPTER 3

The Flowing of Property at Death

An individual's death begins the process of transferring assets to others. The estate consists of the assets to which one has title or legal rights of ownership. These rights depend on the method by which the property was acquired.

Non-Tax Considerations in Evaluating Current Plan

Changes in the family's personal and economic situation will affect the appropriateness of the estate plan. Therefore, the plan needs to be reviewed with a financial counselor periodically, particularly after any of the following events involving a member of the family occurs: marriage, birth of a child or a grandchild, serious illness, shifting residence to a new state, divorce, retirement, receipt of an inheritance, or vesting of a major corporate benefit, such as a survivor pension.

It is important to periodically attempt to foresee the disposition of a client's assets under the current plan and discuss the conclusions with the financial counselor. A client may well find that the disposition contemplated is not effectively accomplished under all circumstances.

Use of Trusts to Provide for the Athlete's/Entertainer's Family After Death

Clients may conclude that a complete distribution of assets directly to their family members may not be the most desirable approach. As an alternative, the establishment of a trust or trusts needs to be considered.

A trust is a legal device that allows one person or legal entity to hold and administer property for the benefit of another. Contrary to some popular misconceptions, trusts are not necessarily expensive to maintain, nor are they inflexible. Moreover, trusts need not eliminate beneficiaries from the decision-making process. Furthermore, others, not only the very wealthy, can benefit from them.

Durable Power of Attorney

In most states, it is possible to execute what is known as a "durable power of attorney" to facilitate the management of assets in the event of a disability. In a typical marital situation, each spouse designates the other as attorney-in-fact and someone else as an alternate or successor attorney-in-fact. The power of attorney is designed to remain valid even if the person creating the power becomes incompetent - thus its durable ability to assist in the management of personal and financial affairs such as:

- Naming Advisers in Addition to Executors

This concept is becoming increasingly popular in certain situations:

For example: If there are valuable collectibles, the client may want to specify in a will that an expert is to be consulted before the executors or trustees make any final decision concerning such assets.
Advisers may also be added to oversee investment management results.

- Selecting a Trustee

An important consideration in the creation of a trust is the selection of a trustee - the individual or institution that will be responsible for the management, investment, and distribution of funds. While the advantages of investment management are not limited to a professional trustee, whenever an individual is selected in such a fiduciary capacity, the level of competence will vary depending on such factors as experience and business judgment. Maybe more important is the fact that a corporate trustee's existence is perpetual, whereas an individual trustee may die or become incapacitated, thereby negating the advantage of continuity of trust administration. The cost of employing a corporate fiduciary can, of course, weigh on the other side.

LIFETIME GIFTS

Gift-giving programs may play an important role in your estate planning.

The gift tax uses the same marital deduction and unified tax credit as the estate tax. Because of the unlimited marital deduction, there is no gift tax on transfers between spouses who are both U.S. citizens.

There is an annual exclusion of $10,000 ($20,000 if made with spouse) for gifts per each donee.

There are special rules for gifts to non-U.S. citizen spouses:

- In general, non-U.S. citizen spouses may receive up to $100,000 annually tax-free.
  - This $100,000 is an annual exclusion from the applicability of the federal gift tax.
  - Any transfers in excess of the $100,000 will result in a reduction of the federal unified credit.

MARITAL DEDUCTION

Money or property transferred from one spouse to the other, either in life or death, is not subject to gift or estate tax, provided it is given outright or is transferred to a trust and the trust terms provide that:

- The receiving spouse must be entitled to all the income from the property for life.
- The income from the property must be paid at least annually.
- No one may have the power to appoint any part of the property to anyone other than the receiving spouse while the receiving spouse is alive.
IRREVOCABLE LIFE INSURANCE TRUSTS AND THE ASSIGNMENT OF LIFE INSURANCE POLICIES

To keep insurance death benefits out of the gross estate, someone else - for example, the spouse or an irrevocable life insurance trust - must own the policy.

Because of the unlimited marital deduction, assignment of life insurance may have no tax-saving advantage when it is assigned to a spouse. However, for single individuals, or married persons who assign the policy to a child or a trust, substantial tax savings that are not otherwise available may be generated for the family.

An important aspect of this device is that death tax savings are possible immediately upon the death, when the financial needs of the family are typically greatest. This technique involves giving ownership of all rights pertaining to the insurance to another individual or trust. After three years have passed, the proceeds will no longer be taxable in the estate. If new insurance policies are purchased, there is no three-year inclusion rule if the proper procedure is followed in establishing the trust and funding it. In some cases, it is advisable to take reduced paid-up insurance on the current policies and have the new owner purchase new policies.

Keep the following in mind:

- Charitable Gifts

Gifts to charity at death are deductible in the calculation of estate taxes. However, since such gifts save estate taxes only at the marginal estate tax rate, they necessarily involve a net reduction in assets available to the family. Consequently, charitable intentions - at the expense of the survivors - must be the motivation.
CHAPTER 3

CASE STUDY 3-1

Directions:

■ Spend a few minutes reviewing the case information.
■ Discuss the solutions with the other members of your group.
■ Be prepared to explain the group's solution to the others.
■ Use the space provided for your notes.

Assume:

■ Bob Smith, NY Jets first-round Draft Choice

<table>
<thead>
<tr>
<th>Gross Amount of Contract</th>
<th>$1,700,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Signing Bonus</td>
<td>300,000</td>
</tr>
<tr>
<td>Reporting Bonus</td>
<td>20,000</td>
</tr>
<tr>
<td>First-Year Salary 200,000</td>
<td></td>
</tr>
<tr>
<td>Second-Year Salary</td>
<td>350,000</td>
</tr>
<tr>
<td>Third-Year Salary</td>
<td>450,000</td>
</tr>
<tr>
<td>Fourth-Year Salary</td>
<td>600,000</td>
</tr>
<tr>
<td>Player Expenses</td>
<td>50,000</td>
</tr>
<tr>
<td>Agent's Fees 5% of Annual Compensation</td>
<td></td>
</tr>
</tbody>
</table>
CASE 3-1 (Continued)

Investment Criteria

- Capital Preservation
- High Yield (12%)
- Growth (7% Annual Rate)

Player Budget

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>$3,000/Month</td>
</tr>
<tr>
<td>Second</td>
<td>$3,000/Month</td>
</tr>
<tr>
<td>Third</td>
<td>$4,000/Month</td>
</tr>
<tr>
<td>Fourth</td>
<td>$4,000/Month</td>
</tr>
</tbody>
</table>

- Bob Smith has retained your firm to help him financially plan his future. Prepare a list of financial planning suggestions and objectives for Bob.

Notes:
CHAPTER 3
CASE STUDY 3-2

Client: Jane Young, a professional entertainer, in her late 20s.

Annual

Income: Salary/Bonus $427,000
Expense\(^1\) (120,500)

Present Investment Portfolio

U.S. Government Securities Trust $110,000
Real Estate (Fair Market Value) 250,000
Growth Securities 190,000
Cash (Money Market Funds) 80,000

Portfolio Yield $12,514 Taxable
$7,000 Nontaxable

Ms. Young has two years and an option year remaining on her contract.

She and her husband live with their two children (8 and 10).

She has no life insurance other than that provided by a union.

Ms. Young has approached you for suggestions regarding a financial plan. Please advise.

Notes:

\(^1\) Budget expense plus seven percent agent fee.
Financial Planning Suggestions and Objectives:

- Structure compensation to minimize tax liability.
- Utilize possible withholding exceptions when receiving signing bonus.
- Consider bunching itemized deductions to escape 2%/3% floors.
- Prepare a budget for the taxpayer.
- Consider prepaying state and local taxes.
CHAPTER 3
SUGGESTED SOLUTIONS — CASE STUDY 3-2

Financial Plan:

- Consider a pension/profit sharing plan.
- Consider increasing life insurance.
- Consider a disability policy to cover her occupation.
- Prepare wills with the appropriate trusts for their children.
- Plan for the children's education.
CHAPTER 4
FORMS OF BUSINESS

OBJECTIVES

- Understand the developments affecting the use of personal service corporations.
- Use tax planning opportunities available for team ownership.

INTRODUCTION

In the mid-1970's, the sports industry began a period of tremendous growth which has yet to slow down. Player salaries now account for a greater percentage of total franchise expenses, and in many cases the owners report no profit at all. The average salary for baseball and basketball players has increased more than fifteen times what it was in 1975, with football not far behind.

In addition to earning megabucks on the field, many players moonlight as expert marketers. This off-the-field business entails lending their name, likeness, and image to companies that believe an athlete's endorsement of a product will result in higher sales. As a second career for the athlete, it doesn't require much time and pays handsome rewards.

PERSONAL SERVICE CORPORATION

In an era of million dollar athletes, players, agents, and tax advisors are constantly seeking ways to reduce their tax bills by taking advantage of certain tax laws. One such device which was popular in the early 1980's was the use of the personal service corporation (PSC).

A PSC is a corporation, defined in the IRC, whose principal function is to contract for the performance of personal services, usually by the majority shareholder. However, it is not any corporation where personal services are the main ingredient. PSCs relate to only eight types of professions under the IRC. (Note further, PSCs include performing artists but not creative artists.) In its substance, an athlete forms a corporation of which he is the majority shareholder. He then signs an employment contract with the corporation which basically requires him to perform personal services at the corporation's discretion (either services for the corporation or for a third party on the corporation's behalf). Subsequently, the corporation enters into a contract with a third party (usually a professional team or an advertiser) that requests the athlete's services. Instead of the athlete being paid directly from the third parties, his employer the personal service corporation is paid, and then it, in turn, issues a salary to the athlete.
FORMS OF BUSINESS

Background

There were several reasons for doing business through a PSC. The first reason was deferral of income. If an athlete worked for the PSC rather than a third party (professional team, advertiser, etc.), he could essentially achieve a perpetual one-year deferral of his income by making the PSC's year-end different from his own.

Example 4-1:

- Joe Williams has a December 31 year-end.
- He forms a PSC called Prostar Inc., which has a January 31 year-end.
- Prostar Inc. receives payments from February 1, 1996, to December 31, 1996, for services that Joe performed during that same period.
- In January 1997, Prostar remits a salary to Joe for the entire amount of money collected (less expenses).
- If the payments were made directly to Joe by the third parties, he would have to report them by April 15, 1997.

However, since the corporation received them and did not remit them to Joe until January 1997, he does not have to report them until April 1998, a one-year deferral.

The second reason athletes formed PSC's during the 1980's was to exploit the favorable pension laws that allowed self-employed individuals to deduct amounts contributed to pension plans as a "self-employed" employee. Athletes employed by a professional team may participate in a plan only if one is in fact established by their employer. Through the use of a PSC, athletes could achieve a huge tax-deferred retirement account and a current deduction in taxable income.

Another advantage of using PSC's was the opportunity to accumulate income at lower tax rates. When individual rates were substantially higher than corporate rates, individuals could leave the first $50,000 in the corporation and pay tax at 15% instead of individual rates which at times reached as high as 70%. The money could be invested and withdrawn in a year when the individual's income was low (thus causing a lower tax bracket) or withdrawn when individual statutory rates were much lower.
CASE LAW

In addition to a host of Code sections restricting the use of personal service corporations, there have been many precedent-setting cases in the area as well.

One such case was *Gary A. Sargent and Stephen Christoff v. Comm.*, 929 F2d 1252. Sargent and Christoff (Appellants) were hockey players for the Minnesota North Stars Hockey Club. Both players created personal service corporations and entered into employment contracts with their respective PSC's. The corporations then contracted with the club to provide appellants' services to the club. Each PSC was paid a stipulated sum by the club and, in turn, paid out an agreed upon salary to each player. The difference between what the club paid the PSCs and what the PSCs paid the players was contributed to a qualified pension plan on the players' behalf.

Each PSC filed the proper incorporation papers and withheld and paid the applicable federal and state employment and unemployment taxes.

The commissioner, however, elected to bypass the PSC and tax appellants on the entire amount the PSC received from the club by virtue of common law rules for determining employer-employee relationships. Additionally, the commissioner proposed to disallow the pension deductions.

In 1989, the Tax Court upheld the commissioner's assessment on the grounds that the club exercised sufficient control over the appellants' services to consider them as employees of the club and not their respective PSCs.

The Court reasoned that since the club provided the players with hockey equipment and uniforms, as well as controlling the scheduling of games, dictating who would play and for how long, and formulating a game strategy, the appellants were employees of the club and not their PSCs.

Appellants unsuccessfully argued that although the coach developed the strategy, it was they, by virtue of their talents, who exercised control over how to accomplish the strategy. Consequently, the Tax Court ruled in favor of the respondent and the amounts paid to the PSCs were deemed to be fully taxable to the appellants.

The appellants appealed the decision and in April 1991 the Court of Appeals for the Eighth Circuit reversed the opinion of the Tax Court and held that the appellants were actually employees of their respective PSC's.

The Circuit Court held that it is not necessary that the employer (PSC) actually direct or control the manner in which the services are performed by the employee. It is sufficient if it has the right to do so.

**Required Elements for a PSC**

According to a 1980 Treasury Regulation [31.3121(d)-1(c)(2)], two necessary elements must be met before the corporation (PSC) may be considered the true controller of the service provider (player).
FORMS OF BUSINESS

First: The player must be an employee of the corporation whom the corporation has the right to control in a significant way.

Second: There must exist between the PSC and the club a contract recognizing the corporation's controlling position.

The appellants indeed satisfied both these requisites as evidenced by the written contracts. Furthermore, the Eighth Circuit held that the fact that each player took steps to enhance his retirement fund should be of no consequence to any court. It was the intent of Congress to bestow certain benefits on employers and employees and efforts to obtain these benefits should not be construed as illegal tax evasion or avoidance. Finally, once a corporation is formed and all organizational and operational requirements are met, it should be recognized for tax purposes regardless of the reasons for which it was formed. It is not the Court's responsibility to determine the motivation behind appellants' decision to incorporate.

The Internal Revenue Service staunchly opposes the findings of the Eighth Circuit. The IRS contends that "the manner in which the taxpayers rendered their services to the team, subject to the coach's and club's control, is the determinative factor in resolving the question of by whom the taxpayers were actually employed." The IRS has vowed to continue litigation in this area in all circuits except the Eighth.

After Sargent, the IRS enjoyed another Tax Court victory within the 5th Circuit in a case involving a team sports player and his loanout corporation. In Leavell v. Commissioner, 104 T.C. 140 (1995), the IRS attacked the use of a loanout corporation by a professional basketball player and was successful in persuading the Tax Court to uphold the conclusions it reached in Sargent. The Tax Court specifically stated it believed the 8th Circuit Court of Appeals was wrong in overturning Sargent and then, in an obvious attempt to thwart a similar appeal to the 5th Circuit, proceeded to address the deficiencies the 8th Circuit found in their earlier decision. A two-pronged test was cited in both Sargent and Leavell, which had evolved from case law beginning with Lucas v. Earl, 281 U.S. 111 (1930), and had been applied in a string of earlier cases which held that income was not reallocable under the assignment of income doctrine when both prongs were met [Keller v. Commissioner, 77 T.C. 1014 (1981), affirmed, 723 F.2d 58 (10th Cir. 1983); Pacella v. Commissioner, 78 T.C. 604 (1982); Johnson v. Commissioner, 78 T.C. 882 (1982), affirmed, 734 F.2d 20 (9th Cir. 1984); Bagley v. Commissioner, 85 T.C. 663 (1985), affirmed, 806 F.2d 169 (1986); Haag v. Commissioner, 88 T.C. 604 (1987), affirmed, 855 F.2d 855 (8th Cir. 1988); and Pflug v. Commissioner, T.C. Memo 1989-615]. The two-pronged test indicates that for a loanout corporation to be respected as the employer of the service-provider (i.e., in Sargent and Leavell, the athletes), the corporation must have the right to direct and control the activities of the service-provider in a meaningful sense and the loanout corporation must be recognized by the service-recipient (i.e., in Sargent and Leavell, the team), preferably by contract, as the true employer of the service-provider. In deciding Leavell, the majority opinion stressed the manner and means analysis of the IRS, while the dissenters felt the two-pronged test supported the validity of the loanout corporation. It is important to note, however, that Sargent and Leavell involved taxpayers who were athletes performing in a team sport. As the nature of team sports places the athlete squarely under the control of the coach or manager, as well as the team management, throughout the playing season, and in many cases the off-
season as well, these taxpayers were easy targets for the IRS. In fact, in *Sargent* and *Leavell*, the IRS argued for the Tax Court to reject the two-pronged test entirely and apply a so-called team sports doctrine. While team sports athletes do have similarities with performing and creative artists, the latter will typically have far more freedom in their endeavors and it remains to be seen if the IRS can attack their loanout corporations as easily. It should be mentioned that the *Pflug* case did involve an actress and, although slightly different issues were at stake, a different conclusion was reached. In a case decided after *Leavell, Idaho Ambucare Center, Inc.*, *v.* United States, 57 F.3d 752 (9th Cir. 1995), the taxpayer's position was sustained in a situation that is arguably more analogous to an artist's loanout corporation than either of the team sports cases. In this case, the IRS assessed payroll tax deficiencies against a medical corporation that contracted with a doctor's loanout corporation for the doctor's services. The IRS argument that the loanout corporation should be ignored since the medical corporation was the de facto employer of the doctor was rejected. The court recognized the contract between the loanout corporation and the medical corporation to be representative of the true relationship between the parties. The contract between the corporations stipulated that the medical corporation would not provide the doctor with employment benefits and that the doctor was not the employee of the medical corporation. The court's finding was that the two-part test was satisfied by the relationships of the parties and the contract between the corporations, even though the doctor did not have an employment agreement with the loanout corporation.

**LEGISLATION**


*Disallowance of Graduated Tax Rates*

One such restriction is the disallowance of graduated tax rates for PSC's which serves to nullify the shifting of income to lower tax brackets. Section 11(b)(2) states in pertinent part that the amount of tax imposed on a qualified personal service corporation shall be equal to 35% of taxable income.

*Tax Deferred Loophole Closed*

Additionally, the tax deferral loophole was sewed up by Section 441(i), which mandates that a personal service corporation use a calendar year unless it can establish a business purpose for not doing so. For purposes of Section 441(i), the deferral of income is not deemed to be a valid business purpose.

*Cash Basis*

Section 448(d)(2)(A) was enacted to limit the use of the cash method by certain professions in personal service corporations. Among these professions are health, law, engineering, architecture, accounting, performing arts, and consulting. The performance of services by athletes, however, does not fall within any of the categories.
FORMS OF BUSINESS

Reallocation of Income and Deductions

Finally, Section 269(A) grants the IRS the authority to reallocate income and deductions from a personal service corporation to the corporation's employee-owner if the following criteria are satisfied:

1. The corporation performs substantially all of its services for one entity or a group of related entities,
2. The corporation's principal purpose is the avoidance or evasion of federal income tax, and
3. The reallocation is necessary to prevent the avoidance or evasion of income tax or to clearly reflect the income of the corporation or the corporation's employee-owners.

The determination of whether Section 269(A) should be applied to a personal service corporation depends upon whether the formation of the corporation affords the owner certain tax-related fringe benefits and income-shifting devices that otherwise would have been unavailable.

Note: The "performing arts" is mentioned under Sec. 448(d)(2)(A).

However, many individuals in the entertainment industry operate through wholly owned loanout C or S corporations to obtain tax benefits, although there is substantial question whether these loanout corporations will be respected.

SPORTS FRANCHISES

Players are not the only ones being affected by the tax law. The owners also face a plethora of complex and ever-changing rules which have a significant legal and economic impact on operations.

CLASSES OF ASSETS

Franchise Rights

There are only three classes of assets in a sports franchise; the first being the actual rights of the franchise (franchise rights). These rights include such intangible assets as:

- The right to share in revenue collected at the particular sporting event,
- The right to share in revenues from national broadcasting,
- The right to license the franchise name and share in proceedings generated from its use, and
- A host of other rights and benefits from being a member in a league.
As mentioned, these rights are intangible assets with indefinite useful lives and, consequently, they cannot be depreciated or amortized.

A precedent-setting case in this area is *McCarthy v. United States*, 807 F2d 1306, and involves the 1973 purchase of the New York Yankees. The plaintiffs (purchasers of the team) argued in vain that the part of the purchase price that was allocated to existing television broadcasting contracts should be amortizable over the remaining life of the contracts. The unfavorable decision of the Sixth Circuit was predicated on the presumption that the television contracts were an integral part of the franchise which did not have an ascertainable useful life and therefore no deduction for amortization would be permitted.

**Player Contracts**

The second class of assets which account for significant amortization are player contracts; mainly the costs incurred to purchase the player contract and the costs of bonuses paid to the player. The IRS has held that these intangible assets have a useful life that extends beyond the taxable year in which the cost was incurred and therefore must be capitalized (Sec. 167). Prior case law has established useful lives in the range of five years.

**Tangible Personal and Real Property**

Finally, common assets to most businesses are tangible personal and real property. For tangible property, the year in which the asset was placed in service will dictate what method of depreciation will be used, although straight line is always an option. Nonresidential real property, if acquired after 1986, will have a useful life of 31.5 years. A viable alternative to purchasing real property is to lease. In the case of a lease, the yearly payments will ordinarily be deductible with the lease acquisition costs being amortized over the life of the lease.

**TAX-EXEMPT ORGANIZATIONS**

In a Technical Advice Memorandum, the Internal Revenue Service took a position that amounts received by the Cotton Bowl [a tax-exempt organization under Section 501(a)] from Mobil Corporation for being named the sponsor of the event constituted unrelated taxable income, subject to tax under Section 511 of the Internal Revenue Code.

In reaching their conclusion, the IRS determined that the payments made to the Cotton Bowl represented income from a trade or business, that the trade or business was regularly carried on by the organization, and that the conduct of the trade or business was not substantially related to the organization's performance of its tax-exempt function.

In the past, the IRS concluded that limited recognition of a donor's generosity was an unsubstantiated return benefit and not unrelated taxable income [see Rev. Rul. 67-342, Rev. Rul. 77-367, Reg. Sec. 1.509(a)(3)(f)(3)]. However, the benefits received by Mobil Corporation differ in many respects from what the IRS previously recognized as insignificant. The IRS has concluded that the organization was
FORMS OF BUSINESS

providing much more than mere recognition. In fact, it was a substantial return benefit expected by Mobil.

The IRS argued that since the organization generates more in proceeds from the agreement than it expends in providing services, the organization generated some profit from the service it was providing. Additionally, the IRS determined that the organization's activity was not substantially related to its exempt function because the addition or distribution of the funds it received did not contribute importantly to the organization's educational purpose.

Finally, the IRS concluded that the income-producing activity was regularly carried on. A review of the contractual agreement indicated that the organization services were systematic and consistent over a relatively significant period of the time, unlike National Collegiate Athletic Association v. Comm., which received proceeds from advertising solely during a four-day period in the entire year.

Consider: As soon as possible, organizations should review their contracts and assign values on a factual basis to the various rights and benefits obtained by the sponsor. In this way, certain payments, if not all, by a sponsor may be exempt from tax.

TAX PLANNING

There are numerous tax planning opportunities available to a business regardless of the form of organization selected. Although tax planning opportunities are too extensive and too personalized to prepare an exhaustive list, a brief comparison of the S corporation, limited liability company, partnership, and C corporation is mentioned here.

Obtaining an Ownership Interest

The situation of any taxpayer planning to contribute property in exchange for an ownership interest should be evaluated. In some instances, it may be in the individual's best interest to seek an alternative method of obtaining an ownership interest.

For example: Property with a basis in excess of its market value may provide the owner greater benefits if leased to the business.

Adjustments to Business Assets

Taxpayers purchasing an interest in a business that owns appreciated assets should be aware that no adjustment to the business' assets can be made except in the partnership, and only then if a special election is in effect. This is particularly relevant to the purchasing partner or S shareholder. When the election cannot be made, the purchase price will exceed the asset bases for purposes of depreciation, depletion, amortization, gains, and losses. Therefore, it is quite possible the purchase price should be adjusted below market value when no election exists. This, of course, is quite important to the seller.
CHAPTER 4

BASIC PRINCIPLES

S Corporations

The S corporation has many of the same advantages and disadvantages as a partnership.

- Unlike general partners, however, S shareholders have limited liability. This factor often is the major reason for incorporating a business.

Some of this protection, however, may be lost if shareholders are required to guarantee corporate liabilities.

- Regardless of the restrictions, shareholders are protected from a number of debts that are not guaranteed.

To achieve this benefit, owners must give up much of the flexibility available to the partnership and are subject to more filing requirements and other formalities.

Partnerships

Two significant advantages of the partnership are not available with any other organizational form.

- One is the ability to specially allocate partnership items among the partners.

This can be particularly useful in alleviating inequities and for tax planning when marginal rates differ among the owners.

- A second unique attribute of the partnership is the ability to adjust the basis of the assets when a capital interest is sold and when gain is recognized on distribution of partnership assets.

- An important disadvantage of the partnership is that an owner cannot be an employee.

As a result, owner/employee benefits are not deductible by the partnership and the owner has self-employment income.

C Corporations

- In addition to limited liability for its shareholders, the C corporation's major advantage is that it is a separate taxable entity.

As a result, owner/employee benefits are deductible expenses.

- In addition, business income is not taxable to owners until distributed to them.
FORMS OF BUSINESS

As is often the case, the major advantage also can be a disadvantage.

- The separate taxable entity concept results in double taxation when corporate profits are distributed to shareholders.
- It also means that neither losses nor the character of income or deductions flows through to shareholders.
- The corporate form may be a disadvantage for businesses with sales of depreciable realty.

Section 291(a)(1) serves to reclassify certain Sec. 1231 gain of either an S or C corporation from long-term capital gain to ordinary income. This section, however, is not applicable to a partnership.

LLCs

Limited liability companies (LLCs) are, generally, the most attractive form of doing business today. They combine the best features of partnerships, limited partnerships, S corporations and regular corporations—limited liability, tax pass-throughs and flexibility. LLC statutes have been adopted in all states so it is possible to set up an LLC anywhere in the country. LLCs may engage in the same types of business that can be conducted by partnerships and corporations.

ADVANTAGES OF LLCs

Limited Liability

One of the biggest advantages of doing business in LLC form is the liability protection afforded through an LLC. Owners of LLCs (called "members") are not liable in their personal capacity for the debts and obligations of their company. Instead, members have the same type of insulation from liability that exists for shareholders in corporations and the limited partners of partnerships.

Members retain limited liability even if they are actively involved in the management of the company. If desired, a separate class of "managers" may be appointed to operate the LLC. These managers will still not be personally liable for company obligations, whether or not they are also members.

- Given the fact there has yet to be significant litigation concerning the liability protection afforded by LLCs, it is presently unclear under what circumstances, if any, a litigant would be permitted to "pierce the corporate veil" and reach individual members of an LLC.

Tax Considerations of LLC Status

If properly structured, an LLC will be treated as a partnership for federal tax purposes. In that event, a federal entity level tax will not be imposed on the LLC and all items of income will flow through to the
individual members of the LLC. Members will be able to make special allocations of items of income and loss pursuant to partnership rules; and they will be able to take a deduction for losses to the extent of their basis in the LLC in the same taxable year that entity level losses are incurred. Property held by the LLC can be liquidated without triggering a taxable event at the entity level. Generally, such an LLC must conform its taxable year to that of its members. Furthermore, LLCs treated as partnerships for federal income tax purposes will not be subject to the corporate alternative minimum tax (AMT).

TAX TREATMENT AS A CORPORATION OR PARTNERSHIP

Even if an entity qualifies as an LLC under state law, it is not guaranteed treatment as a partnership for federal tax purposes. Moreover, an LLC entity that is characterized as a partnership for federal income tax purposes may still be classified under the laws of the various states as something else for tax purposes; e.g., a corporation or a trust.

Partnerships/S Corporations/C Corporations Compared

Generally, newly formed businesses provide greater benefits if organized as a partnership or S corporation. This is because operations in the early years often produce net losses.

- In these two types of businesses, losses are deductible by the owners (subject to the limitation on passive business losses).

In contrast, a C corporation's losses must be carried back or forward to offset corporate income in those years. If losses are incurred in the first years, no tax savings will be obtained from these losses until sometime in the future and then most likely at the lowest corporate rates.

- Another situation where the flow-through concept is important is when owners need to have earnings distributed to cover their current living expenses.

This, of course, is dependent on the marginal rates of all taxpayers and the percentage and amount of earnings distributed.

Family businesses provide excellent income-splitting opportunities among family members. For example, children can be employees of their parents' businesses. The amount of salary paid is, of course, dependent on the work performed. However, significant tax savings can be achieved.

The corporate form often is an advantage for owners who are selling their interests. Stock sales result in capital gains when the business is successful but often qualify for ordinary loss treatment if unsuccessful. The partnership may have the opposite effect.

- That is, gain is ordinary income to the extent of unrealized receivables, substantially appreciated inventory, and depreciation recapture.
But sales at amounts below basis are capital losses. This may be an important consideration when establishing a new business or investing in a business for a limited period of time.

- From this perspective, the S corporation combines the advantage of the flow-through concept with the capital gain/ordinary loss benefit when the ownership interest is sold.

### COMPARATIVE ANALYSIS OF BUSINESS FORMS

<table>
<thead>
<tr>
<th>Basic Concepts</th>
<th>Items for Comparison</th>
<th>Proprietorship/Proprietor</th>
<th>Partnership/Partner</th>
<th>S Corporation/Shareholder</th>
<th>C Corporation/Shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What are the restrictions on the number of owners or who may be an owner?</td>
<td>1. One owner who must be an individual</td>
<td>1. None, except there must be at least two owners</td>
<td>1. No more than thirty-five shareholders (and some states set a minimum number) who must be individuals, estates, or certain trusts</td>
<td>1. None, except some states set a minimum number of shareholders</td>
<td></td>
</tr>
<tr>
<td>2. Are owners liable for business debts that they have not personally guaranteed?</td>
<td>2. Yes</td>
<td>2. Yes for general partners but no for limited partners</td>
<td>2. No</td>
<td>2. No</td>
<td></td>
</tr>
<tr>
<td>3. What are the appropriate tax forms and schedules and who files them?</td>
<td>3. Schedules C, SE, and all supporting schedules and forms are filed with proprietor’s Form 1040</td>
<td>3. Form 1065 and Schedules K-1 are prepared at the partnership level; partners report their shares on Schedules E, SE, and other supporting schedules and file them with their Form 1040s</td>
<td>3. Same as partnership except Form 1120S and its Schedules K-1 are prepared at the S corporation level</td>
<td>3. Form 1120 and all supporting schedules are filed for the C corporation; shareholders report dividend income on Schedule B and file it with their Form 1040s</td>
<td></td>
</tr>
<tr>
<td>4. Who is the taxpayer?</td>
<td>4. Proprietor</td>
<td>4. Partners</td>
<td>4. Shareholders (but the S corporation may be subject to a special tax on certain net LTCGs and excess passive investment income)</td>
<td>4. C corporation and shareholders are taxed on dividend income when corporate earnings are distributed</td>
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<tr>
<td>Basic Concepts</td>
<td>Items for Comparison</td>
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<tr>
<td>5. Do owners have self-employment income from the business?</td>
<td>5. Yes, the net income from Schedule C</td>
<td>5. Yes, each general partner's share of net ordinary income less passive income from Form 1065 plus his or her guaranteed payments; but for limited partners, only their guaranteed payments from services provided to the partnership</td>
<td>5. No</td>
<td>5. No</td>
<td></td>
</tr>
<tr>
<td>6. Must the business' taxable year be the same as the majority owners?</td>
<td>6. Yes</td>
<td>6. Yes, but IRS permission may be obtained for another year end if a business purpose exists</td>
<td>6. Same as partnership</td>
<td>6. No, any generally accepted accounting period may be used</td>
<td></td>
</tr>
<tr>
<td>Owner-ship Interest</td>
<td>Proprietorship/Partner</td>
<td>S Corporation/Shareholder</td>
<td>C Corporation/Shareholder</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>1. Are contributions of assets for an owner-ship interest taxable transactions?</td>
<td>1. No, exchange, all tax attributes transfer to the business except the lower of basis or market value must be used for non-business assets transferred; the term &quot;owner-ship interest&quot; is not applicable</td>
<td>1. No, same as proprietorship except ownership (capital) interest is applicable</td>
<td>1. Same as S corporation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Are distributions of cash includable income to owners?</td>
<td>2. No, except a distribution in excess of the partner's basis in the partnership is treated as a partial sale of the ownership interest</td>
<td>2. No, same as partnership except share-holders' basis for this purpose is their basis in stock and not in corporate debt owed to them</td>
<td>2. Yes, they are nontaxable distributions by the corporation and dividend income to shareholders if from the C corporation's earnings and profits; otherwise it may be same as S corporation in certain situations that are beyond the scope of this chapter</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Do distributions of property result in includable income to either the business or the owners?</td>
<td>3. No, same as contributions except the reverse</td>
<td>3. Yes, S corporation must recognize all realized gain; shareholder receives the assets at their market value with no transfer of tax attributes and any market value in excess of the shareholder's basis in stock (not debt) is treated as a partial sale of the stock</td>
<td>3. Yes, C corporation must recognize realized gain— but not loss if a nonliquidating distribution; shareholders have dividend income equal to the market value of the assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. May an owner enter into taxable transactions (sales, loans, lease arrangements, etc.) with the business?</td>
<td>4. No</td>
<td>4. Yes, when acting in a nonpartner capacity, but subject to related party restrictions</td>
<td>4. Same as S corporation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset Transfers Between Owners and Their Business</td>
<td>Items for Comparison</td>
<td>Proprietorship/Proprietor</td>
<td>Partnership/Partner</td>
<td>S Corporation/Shareholder</td>
<td>C Corporation/Shareholder</td>
</tr>
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<td>---------------------------</td>
</tr>
<tr>
<td>5. May an accrual basis business deduct accrued expenses to cash basis owners?</td>
<td>5. No, not applicable</td>
<td>5. No, deductible only when paid (except see 6 below)</td>
<td>5. Same as partnership</td>
<td>5. Same as partnership and S corporation</td>
<td></td>
</tr>
<tr>
<td>6. Are accrued expenses of the business includable income to cash basis owners? If yes, when?</td>
<td>6. No, not applicable</td>
<td>6. Yes, when received except guaranteed salary and interest on capital are includable when accrued to a partner whose capital interest exceeds 5%</td>
<td>6. Yes, when received except guaranteed salary and interest on capital are includable when accrued to a partner whose capital interest exceeds 5%</td>
<td>6. Yes, when received</td>
<td></td>
</tr>
<tr>
<td>7. Can owners be employees of the business and be paid salaries subject to employment taxes and withholding</td>
<td>7. No</td>
<td>7. No, unless partner's capital interest does not exceed 5%</td>
<td>7. Yes</td>
<td>7. Yes</td>
<td></td>
</tr>
<tr>
<td>8. Are fringe benefits for owner employees deductible expenses?</td>
<td>8. No</td>
<td>8. No, unless partner's capital interest does not exceed 5%</td>
<td>8. No, except for a 2% or less shareholder</td>
<td>8. Yes</td>
<td></td>
</tr>
<tr>
<td>9. May the business use the cash method?</td>
<td>9. Yes</td>
<td>9. Yes, unless it qualifies as a tax shelter or has a C corporation as a partner</td>
<td>9. Yes, unless it qualifies as a tax shelter or has a C corporation as a partner</td>
<td>9. No, unless gross receipts do not exceed $5 million or qualifies under &quot;type of business&quot; exception</td>
<td></td>
</tr>
</tbody>
</table>
# FORMS OF BUSINESS

## Income, Deductions, And Credits

<table>
<thead>
<tr>
<th>Items for Comparison</th>
<th>Proprietorship/Proprietor</th>
<th>Partnership/Partner</th>
<th>S Corporation/Shareholder</th>
<th>C Corporation/Shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is the business a conduit with the original character of the items flowing through to its owners as of the last day of the business' taxable year?</td>
<td>1. Yes</td>
<td>1. Yes</td>
<td>1. Yes</td>
<td>1. No, the business is an entity and the flow through concept is not applicable</td>
</tr>
<tr>
<td>2. How are capital gains and losses treated?</td>
<td>2. As though received by the proprietor</td>
<td>2. Flow through to each partner before short-term gains or losses are netted against long-term gains or losses</td>
<td>2. Same as partnership</td>
<td>2. Net STCGs and net LTCGs are includable in corporate taxable income and taxed at regular rates or net LTCGs may be taxed at 35%; net capital losses are subject to the carryover rules (back 3 years and forward 5 years) as STCLs and deductible against capital gains</td>
</tr>
<tr>
<td>3. How is dividend income treated?</td>
<td>3. Includable income as though received by the proprietor</td>
<td>3. Flow through to each partner as dividend income</td>
<td>3. Same as partnership</td>
<td>3. Includable income with an 80% (100% if from an affiliated corporation) dividend deduction</td>
</tr>
<tr>
<td>4. How are charitable contributions treated?</td>
<td>4. An itemized deduction as though contributed by the proprietor</td>
<td>4. Flow through to each partner as an itemized deduction</td>
<td>4. Same as partnership</td>
<td>4. Deductions may not exceed 10% of taxable income before certain deductions</td>
</tr>
<tr>
<td>5. How are state and local income taxes treated?</td>
<td>5. An itemized deduction as though paid by the proprietor</td>
<td>5. Flow through to each partner as an itemized deduction</td>
<td>5. Same as partnership</td>
<td>5. Deductible expense</td>
</tr>
<tr>
<td>6. How are tax credits treated?</td>
<td>6. As though the credit was earned</td>
<td>6. Qualifying credits flow through to each partner subject to any limitations applicable at the partner level</td>
<td>6. Same as partnership</td>
<td>6. Computed at the corporate level and reduces corporate tax liability</td>
</tr>
</tbody>
</table>
### CHAPTER 4

** Income, Deductions, And Credits **

<table>
<thead>
<tr>
<th><strong>Items for Comparison</strong></th>
<th><strong>Proprietorship/Proprietor</strong></th>
<th><strong>Partnership/Partner</strong></th>
<th><strong>S Corporation/Shareholder</strong></th>
<th><strong>C Corporation/Shareholder</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>8. How is net ordinary loss treated?</strong></td>
<td><strong>8. Includable as a reduction of proprietor’s AGI</strong></td>
<td><strong>8. Flows through to each partner up to that partner’s basis in the partnership; any excess is carried forward</strong></td>
<td><strong>8. Same as partnership</strong></td>
<td><strong>8. Subject to carryover rules (back 3 years and forward 15 years or forward 15 years only) and deductible against net ordinary income</strong></td>
</tr>
<tr>
<td><strong>10. How are items allocated among the owners?</strong></td>
<td><strong>10. Not applicable</strong></td>
<td><strong>10. According to profit and loss ratio or may be specially allocated</strong></td>
<td><strong>10. According to stock ownership ratio</strong></td>
<td><strong>10. Not applicable</strong></td>
</tr>
<tr>
<td><strong>11. Is the basis of business assets adjusted when an ownership interest is sold?</strong></td>
<td><strong>11. Not applicable</strong></td>
<td><strong>11. Yes, if the partners have elected the optional adjustment to basis</strong></td>
<td><strong>11. No</strong></td>
<td><strong>11. No</strong></td>
</tr>
</tbody>
</table>

### Basis In the Business

<table>
<thead>
<tr>
<th><strong>Items for Comparison</strong></th>
<th><strong>Proprietorship/Proprietor</strong></th>
<th><strong>Partnership/Partner</strong></th>
<th><strong>S Corporation/Shareholder</strong></th>
<th><strong>C Corporation/Shareholder</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Is basis affected by business liabilities?</strong></td>
<td><strong>1. Not applicable</strong></td>
<td><strong>1. Yes, a general partner’s basis includes his or her share of partnership liabilities but a limited partner’s basis does not</strong></td>
<td><strong>1. No, except a shareholder’s basis is increased by the amount of debt owed to him or her</strong></td>
<td><strong>1. No</strong></td>
</tr>
<tr>
<td><strong>2. Is basis affected by business income, gains, deductions, and losses?</strong></td>
<td><strong>2. Not applicable</strong></td>
<td><strong>2. Yes, all income and gains increase basis and all expenses and losses (that flow through) decrease basis</strong></td>
<td><strong>2. Yes, same as partnership</strong></td>
<td><strong>2. No</strong></td>
</tr>
<tr>
<td>FORMS OF BUSINESS</td>
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</tbody>
</table>

### Sale of a Business Interest

<table>
<thead>
<tr>
<th>Items for Comparison</th>
<th>Proprietor/Proprietor</th>
<th>Partnership/Partner</th>
<th>S Corporation/Shareholder</th>
<th>C Corporation/Shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What is the character of gains and losses on the sale of a business interest?</td>
<td>1. Each asset is treated as sold individually and the character of the gain or loss is dependent on that asset</td>
<td>1. Capital gain or loss except ordinary income to the extent of partner's share of unrealized receivables, depreciation recapture, and substantially appreciated inventory</td>
<td>1. Capital gains and losses except losses may qualify as 31244 ordinary losses if the corporation meets certain requirements</td>
<td>1. Same as S corporation</td>
</tr>
</tbody>
</table>

### Family Ownership

| 1. Must all owners participate in the management of the business? | 1. No | 1. Yes, all general partners but limited partners cannot | 1. No | 1. No |
| 2. Must a reasonable salary be allocated to family members performing services for the business? | 2. No | 2. Yes | 2. Yes | 2. No |
CHAPTER 4

CASE STUDY 4-1

Directions:

- Spend about 5 minutes reviewing the case information.
- Discuss the solutions with the other members of your group.
- Be prepared to explain the group's solution to the others.
- Use the space provided for your notes.

Your client, Joe Dorsey, is a prominent sports agent. Joe was fortunate enough to have three of his players selected in the first round of the National Football League's draft.

Joe believes his clients will make a substantial amount of money in salary and off-the-field endorsements. Joe has retained your firm to assist him with business tax planning.

Prepare a list of income tax issues to discuss with Joe.

Notes:
CHAPTER 4
SUGGESTED SOLUTIONS — CASE STUDY 4-1

In an era of million dollar salaries, athletes and their tax consultants are constantly seeking ways to reduce their tax liability by taking advantage of certain tax laws.

Listed below are a number of possible ideas to help Joe Dorsey minimize his tax liability:

■ Consider bunching itemized deductions to escape 2% and 3% floors.

■ Consider setting up a personal service corporation (PSC) for Mr. Dorsey. One important advantage of a PSC is that the PSC can adopt a pension or profit-sharing plan for the benefit of the athlete-owner. Although an athlete who is self-employed can also adopt his own pension plan, an athlete who is only an employee of a team can not.

■ Consider a Simplified Employee Pension (SEP) Plan. A SEP is an arrangement whereby an employer can make contributions into Individual Retirement Accounts (IRAs) for all eligible employees.

  The contributions are deductible by an employer, up to 15% of compensation, and are not includible in the employees' taxable income until withdrawn. Contributions are not included or reported on IRS Form W-2.

■ Consider setting up a Keogh Plan. If Mr. Dorsey wanted to set up a Keogh for his 1993 tax return, he would have to do so on or before December 31, 1993. He would have to fund the Keogh on or before April 15, 1994.
CHAPTER 5

STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

OBJECTIVES

■ Work with the different methods for computing state tax liability.

■ Advise clients on their nonresident state tax status.

INTRODUCTION

In these days of continuously escalating salaries, several states, which have been experiencing severe revenue shortfalls, have been attempting to strictly enforce their personal income tax apportionment laws. California, Michigan, Minnesota, New York, and Wisconsin are among the states which have begun to vigorously enforce existing laws levying taxes based on the portion of an athlete's income generated by games played in the state.

Entertainers have multistate problems too. They may work all over the United States. A performer in a national tour of a Broadway play may be in 10 to 15 states during the year. They do not have an allocation issue if they are an employee of the production, since the producer will normally handle this based upon the salary paid while in a particular locale. A performer operating through a loanout, however, will have the burden of allocating, as well as filing, in the affected states.

ALLOCATION METHODS

Duty Days Method

California, Wisconsin and Missouri are among the states that use the "duty days method."

"Duty days" generally means days for which the athlete is compensated such as practice days, actual playing days, and travel days. The method of allocating income earned from the performance of personal services by a nonresident professional athlete under a playing contract is based on a fraction:

■ The numerator is the number of "duty days" spent within the taxing state, and

■ The denominator is the total number of "duty days" spent everywhere for the calendar year.
Games-Played Method

Another method used by several states is the "games-played method."

This method apportions a nonresident athlete's income based on the ratio of the total number of games within the taxing state to the total number of games the athlete is obligated to play under the contract or otherwise during the taxable year.

Residents vs. Nonresidents

For those states having a full-fledged income tax law, the usual rule is to tax residents on all their taxable income from whatever source, and to tax nonresidents on their income which has a source in the particular state in question.

States often define a "resident" as one who is domiciled in the state, or one who is in the state with some degree of permanence. Among the factors that are considered when determining which state a person is a resident of are:

- Whether or not he maintains a dwelling in a particular state,
- Where his family is located,
- Where he is registered to vote,
- Where his automobile is registered, and
- Where his friendship and ties to the community are strongest.

In addition, some states have the "183-day test"; that is, if individuals spend more than 183 days in a state they may be in danger of being considered a resident of that state.

The allocation method used by the various states is by no means uniform. While some states allow all days on duty to be used in the allocation ratio, others allow only the number of days played. As a result, athletes are required to file multiple-state tax returns and must keep abreast of the various state laws and administrative proceedings.

As athletes are paid more and more money, state tax officials have an added incentive to challenge the allocation methods used. The dramatic increase in the number of tax cases involving the personal income taxation of nonresident athletes is clear proof that the states are intent on strictly enforcing their income tax apportionment laws.
ALLEVIATING STATE TAX PROBLEMS

However, all is not lost. If the athlete or the adviser take the following steps, most state tax problems can be alleviated.

- First: The tax consequences for athletes in the various states in which they perform and reside must be determined.

  This requires analysis of the allocation method used by those states.

- Second: The withholding or estimated tax payment requirements for those states must be considered so as to verify that those requirements are being met.

- Third: The amount of any tax credit, allowed by the state in which the athletes reside for income taxes paid to other states, must be ascertained to offset any increase in the athlete's tax liability due to multistate income taxation.

  There may also be reciprocal agreements between the taxpayers' resident state and several states that the athletes play in. These may eliminate the tax liability owed to that particular state.

- Finally: All state tax returns must be filed on time to avoid penalties.

Filing a state tax return is a necessary evil, but professional athletes faced with the possibility of multiple-state income taxation, which may result in legal costs and interest penalties as well as potentially embarrassing media coverage, should reevaluate their position with respect to such taxation so as to mitigate its impact.

STATE-BY-STATE ANALYSIS

Here is a state-by-state analysis of the current tax situation.

NEW YORK

Effective January 1, 1995 New York State changed the method they use regarding the taxation of Non Resident Professional Athletes. The New York source income of a nonresident individual who is a member of a professional athletic team includes that portion of an individual’s total compensation for services rendered as a member of a professional athletic team during the taxable year which the number of days spent within NY State rendering services for the team in any manner during the taxable year bears to the total number of duty days spent both within and without NY State during the taxable year. Travel days that do not involve either a game, practice, team meeting, or promotional caravan are not considered duty days spent in NY State. However, such travel days shall be considered in the total days spent both within and without NY State.
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

Court Cases

In Abdul Jabbar (1982), the Courts reallocated a player’s income based on games played in New York divided by total games played. However, the Court redefined games played to include preseason, regular season and playoff games. (See the decision reproduced at the end of this chapter.)

In Richardson (1985), the taxpayer had been employed by the New York Knicks while he was a New Jersey resident. Richardson argued that, since the Knicks training facility was located outside New York and that numerous days were spent traveling outside New York, the proper allocation should be based on the number of days worked within New York divided by total days worked during the year, including practice days.

Richardson, who began his career with the Knicks in September 1978, determined that he worked 39 out of 122 days in New York that year. On his 1978 nonresident New York State income tax return, he attributed 32% of his basketball earnings to New York State. At that time, this allocation method was sanctioned by a New York State regulation.

However, the New York State Audit Division recomputed Richardson’s allocation percentage based on a games-played method, dividing the total number of games he played in New York by the total number of games he played during 1978. The result was to apportion 55% of the cager’s wages to New York.

The matter was eventually brought before the New York Tax Commission. The Commission held that under the circumstances the days-worked formula prescribed by the regulation did not fairly or equitably reflect the amount of wages Richardson had earned in New York. It adopted the games-played method as a preferable measure of Richardson’s New York generated income. However, the Commission did allow Richardson to include six exhibition games in the games-played formula, thereby increasing the total number of games and the denominator of the tax formula fraction. The Commissioner had previously allowed this in Roy White, State Tax Commission April 9, 1982.

Signing Bonuses

There have been several cases in New York regarding the allocation of signing bonuses to New York. In Gordon Clark a nonrefundable signing bonus paid to a nonresident taxpayer upon signing a contract with the Boston Bruins was not subject to tax as income from New York sources since the signing bonus, given in consideration for the taxpayer giving up his amateur status and free agent status, was not connected with the subsequent performance of the contract in New York.

In Scott R. Hutchinson a bonus paid to a nonresident taxpayer upon signing a contract with the Buffalo Bills was subject to personal income tax and, and was allocable to New York in the same manner as his salary income (games-played method). The court concluded that since the signing bonus was refundable to the team in the event that the player fails to report, to practice with or play for said club, or leaves the club without consent, that the bonus was compensation paid in consideration for services to be performed by the taxpayer.
In *Petition of Wolfley* a signing bonus received by a New York resident prior to his being selected as a playing member of the Pittsburgh Steelers was income received while a part-year resident of New York and subject to tax. Craig Wolfley, whose commitment was to play professional football, had no intention of changing his domicile from New York until he was selected as a permanent member of the Steelers. The time spent at a training camp facility in Pennsylvania reflected an intent to secure employment rather than an intent to change domiciles because, during such period, Mr. Wolfley was present only on a trial basis and would have sought employment elsewhere in the event that he was not offered a position with the Steelers.

Mr. Wolfley's actions following the completion of the training camp, however, including the acceptance of employment and the rental and subsequent purchase of a residence in Pennsylvania were sufficient to establish a change of domicile.

**California**

California uses the duty-days method. Duty days includes all days on which the player's team practices, travels, or plays, beginning with the first day of the club's training sessions through the last game in which the team competes. An agent for the franchise tax board indicated that 220 days is the number of "duty days" for a baseball player. Since California requires employers to withhold on wages earned in California, most professional teams will provide each player with a W-2 for California.

In the Appeal of Joseph Barry Carroll, the player, a basketball player for the Golden State Warriors, challenged the duty-day-method. Carroll, a nonresident of California, tried to apply the games-played method since this resulted in a lower apportionment of his wages to California. The state rejected this appeal arguing that professional athletes are not only paid for playing in their respective games, but are also paid for practicing and traveling.

**Illinois**

There is no specific statute indicating the method of allocating a nonresident athlete's income. However, there is a bill before the Illinois State Senate that would tax pro athletes for wages they earn while playing in Illinois. The bill informally titled "Michael Jordan's Revenge" originated when the Chicago Bulls were playing the Los Angeles Lakers for the NBA championship in 1991. Legislators in Illinois discovered that California had laws that taxed out-of-state professional athletes. The bill is aimed only at athletes from states that levy income taxes on nonresident athletes.

Illinois has a reciprocity agreement which exempts compensation paid in the state to residents of Indiana, Iowa, Kentucky, Michigan, and Wisconsin.
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

The State of Illinois is currently engaged in a tax enforcement program against current and former players from the Chicago White Sox and the Chicago Cubs. Presently, the program is focused only on baseball players.

The Illinois Department of Revenue takes the position that under current Illinois statutes 100% of the compensation paid to a player by a club based in Illinois is taxable in Illinois. Thus, the traditional "duty day" allocation formula is not recognized by Illinois. In addition to requiring players to report 100% of their compensation paid by an Illinois team, Illinois does not permit a nonresident of Illinois to take a credit against his Illinois income for taxes paid to other states. However, Illinois does allow an Illinois Resident to take a credit for taxes paid to other states.

The Major League Baseball Players Association has asked the state of Illinois to litigate a "test case" to determine the constitutionality of the Illinois method for taxing professional athletes. The state of Illinois has agreed to such a test case. As of December 1998 this test case has yet to begin.

MASSACHUSETTS

Nonresident professional athlete's income subject to apportionment includes compensation, incentive payments, bonuses and extras, but excludes signing bonuses and league play-off money. Massachusetts uses the games-played method, and allows exhibition and regular season games to be included in the formula, including games in which the athlete was excused from playing because of injury or illness.

There is a separate calculation for play-off games. The play-off calculation also requires use of the games played method (play-off and World Series games).

MICHIGAN

Duty days for a nonresident professional football player includes the sum of days spent in training camp, practice days, exhibition games, season games, play-off games, bowl games, and travel days during an entire playing season.

Allocations of income paid to a nonresident professional baseball, basketball or hockey player shall be made on the basis of total games played in the league season, including pre-season games. Exhibition and pre-season games played either within or outside Michigan and time spent in training camps are excluded. A signing bonus paid for signing a contract or reporting to a team is not subject to tax. A nonresident professional athlete whose employer is located in Michigan will have Michigan income tax withheld from his compensation. Michigan does not require teams (based outside of Michigan) to withhold income taxes for players who are nonresidents of Michigan. However, the state will impose penalties if a player does not make estimated payments to Michigan. Michigan has entered into a reciprocity agreement with Wisconsin, Indiana, Kentucky, Illinois, Ohio and Minnesota which exempts a non-resident from tax for compensation earned for services performed in Michigan.
MINNESOTA

Apportionment of a nonresident salaried athlete is based on the ratio of the total days spent in state to the total number of days the individual is under a duty to perform for his employer. With respect to nonsalaried nonresident athletes, the assignment of income is based on the athletic contests participated within this state. In 1991, for the first time Minnesota required teams to withhold Minnesota tax for nonresident professional athletes. Minnesota has reciprocal agreements with North Dakota, Michigan and Wisconsin.

OHIO

There is no specific statute which addresses the issue of the taxation of nonresident professional athletes. In Hume vs. Commissioner, Tom Hume, a professional baseball player for the Cincinnati Reds, was successful in his court battle concerning the apportionment of his wages to Ohio. The court ruled that Hume was entitled to an Ohio income tax credit for the days that he played in Florida during spring training even though he received payments for these services during the regular playing season. The tax Commissioner argued that the Reds paid Hume only for the regular playing season. However, under the Uniform Player's Contract, the taxpayer was employed and compensated for exhibition games, practice days, the regular playing season, and, if necessary the League Championship Series and the World Series. The court ruled in favor of Hume and allowed him to allocate out of Ohio the income earned for services performed in Florida.

Ohio has entered into a reciprocity agreement with Indiana, Kentucky, Michigan, and Pennsylvania.

WISCONSIN

"Work days" refers to days during the regular and post season for which the athlete is compensated, such as practice days, travel days and actual playing days. "Travel days" refers to days spent in the state of destination except when the team performs on a travel day, that day shall be considered spent where the performance occurs.

In Kern et al, vs. Wisconsin Tax Appeal Commission, the court ruled that nonresident professional baseball players were allowed to allocate their compensation to Wisconsin on the basis of the ratio of their days in Wisconsin to total days of service in the entire year, including the exhibition season.

The baseball players played for the Milwaukee Brewers, which held its spring training camp and exhibition games outside of Wisconsin. The Department of Revenue argued that the players' incomes were allocable to Wisconsin on the basis of the ratio of regular season days in Wisconsin to total regular season days.
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

Under an administrative rule, the players' salaries were treated as earned only during the regular season and not during the spring training and exhibition games. However, this rule was inconsistent with a statutory provision that a nonresident's personal service income is taxed on the basis of the situs of the services. The rule was also inconsistent with the players' contracts, under which the players were compensated not only for their participation in the regular season, but also in spring training, and were entitled to a payment of a pro-rata portion of their salaries for the spring training and preseason period, even if they did not play in the regular season. Thus, for allocation purposes, the players' total days of compensated service included exhibition days as well as the regular season.

MISSOURI

Personal service income includes exhibition and regular services wages, strike benefits, deferred payments, severance pay, and bonuses paid for playing in championship or playoff, games. Duty days are defined to include the days a nonresident member of a professional athletic team serves in that capacity after the commencement of team activities and begins with the first day he reports to the professional athletic team. During 1993, Missouri began to strictly enforce their rules concerning nonresident athletes. The state requires all professional athletes who played in Missouri in 1990, 1991, and 1992 to file returns. If these returns were filed by December 31, 1993, no penalties were assessed.

KANSAS CITY

Following the lead of Missouri, the city of Kansas City now requires all professional athletes who play in Kansas City to file returns. Kansas City went back only to 1992, and if returns were filed by December 31, 1993, no penalties were assessed.

NEW JERSEY

The games-played method is used. However, preseason and postseason games are not included. Under a reciprocal agreement, Pennsylvania residents are not subject to tax on their compensation paid in New Jersey.

INDIANA

In 1986 the Department of Revenue issued Commissioner's Directive #5, which dealt with the enforcement of the income tax liability incurred by nonresident athletes and entertainers.

Athletes under contract to an Indiana professional sports team incur a tax liability on their entire salary. No apportionment will be permitted for games played out of state because an athlete's compensation is a
predetermined amount unaffected by performance in these games. Similarly, athletes performing for non-Indiana teams incur no tax liability by performing in Indiana.

Indiana has entered into reciprocal agreements with Illinois, Kentucky, Michigan, Ohio, Pennsylvania, and Wisconsin.

PHILADELPHIA

Note: Philadelphia has begun taxing nonresident athletes. Philadelphia uses the duty day method.

IMPLICATIONS

In recent times, due to a reduction in the amount of funds from the federal government and spiraling cost of public services, states have had to find different sources of revenue. One increasingly popular avenue is the taxation of nonresident professional athletes. The states contend that since some portion of the visiting athletes salary is related to games played in the state, it is, therefore, subject to the state taxing authority.

There is some question as to the profitability of such a taxing scheme. The revenues generated by one state can easily be reversed by another state by enacting reciprocal legislation.

From a monetary angle, most athletes may not care which state receives the tax dollars because credits are available for taxes paid to other states. But, a taxpayer who lives in a low-tax state would care, since credits are normally available only up to the rate charged in the home state. Someone working in California will not get a complete credit if they live in a low-tax state (such as Illinois).

All professional athletes should be concerned, however, because of the increased compliance required by law. If athletes fail to comply and states aggressively enforce these laws, penalties and interest could accrue quickly.

STATE POWERS

The first question that needs to be answered is this:

- Do the states have the right to enact and enforce these laws?

Initially, the Supreme Court held that the Commerce Clause gave Congress the power to regulate interstate commerce, and even in the absence of Congressional action, a state could not enact any laws to interfere.
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

- In its decision in *Northwestern-Stockham Valve*, 358 U.S. 450 (1959), the Supreme Court upheld a fairly apportioned net income tax applied to interstate business.

It was now possible for states to tax interstate businesses.

- A popular move is for the state involved to create a second tier tax.

States created a net income tax that would be applied to all corporations who were not subject to the state franchise tax. This so called "second tier tax" would have the same rate structure as the franchise tax, resulting in the same amount of tax as a fairly apportioned franchise tax without Commerce Clause problems.

- In its decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Court held: "Simply put, the Spector rule does not address the problems with which the Commerce Clause is concerned. Accordingly, we now reject the rule of *Spector Motor Services, Inc. v. O'Connor*, supra, that a state tax on the "privilege of doing business is per se unconstitutional when it is applied to interstate commerce, and that case is overruled."

**Four-Prong Test**

*Complete Auto Transit*, resulted in what has become known as the four-prong test. If a state can prove that the four prongs of the test are met, a tax on interstate commerce will pass Commerce Clause scrutiny.

The four requirements are:

1. There must be substantial nexus with the taxing state,
2. The tax must be fairly apportioned,
3. The tax must be nondiscriminatory, and
4. It must be fairly related to services provided by the state.

Although these cases deal mostly with corporations, courts have upheld states' rights to tax individuals based upon the same rationale.

There is some congressional legislation that will override the nexus requirements needed for taxation. This override is provided by Public Law 86-272, which came into existence in 1959 after the *Northwestern-Stockham Valve* decision created a stir among business.

Public Law 86-272 denies the states the power to impose taxes on or measured by net income derived within the state from interstate commerce if "the only business activities carried on within the state" are the solicitation of orders for sales of tangible personal property, where orders are sent outside the state for approval or rejection and are filled by shipment or delivery from a point outside the state.
Most states have statutes allowing them to tax nonresident professional athletes on the portion of their earnings earned in that state. They tend to tax nonresident individuals on income derived by performing personal services in that state. These personal services would include income derived from a profession (i.e., professional athlete).

Given these circumstances, a state would be able to prove all four requirements as provided under the Complete Auto Transit four-prong test.

1. Substantial nexus - They are present in the state specifically because of their income.
2. Fair apportionment - Although it may be specifically outlined by statute (Massachusetts Regulation 62.5A.1), states allow apportionment of income earned from playing professional sports.
3. Nondiscriminatory - Residents are also taxed on this type of income earned in the state.
4. Fairly related to Services provided- For the time they are present in the states professional athletes are obtaining the benefits of police protection and an organized society.

Public Law 86-272 would not help to override the nexus requirement because the individual needs to be involved in the mere solicitation for sales of tangible personal property. Professional sports is obviously a personal service, not a tangible personal property.

Due Process

Another constitutional argument that could be made against a state tax is that it violates the Due Process Clause. The Due Process Clause of the U.S. Constitution, Amendment XIV, Section 1, states, in part, that any state can not deprive any person of life, liberty, or property without due process of law.

There are two tests that must be met in order for a state tax to be valid under the Due Process Clause:

1. There must be some minimum connection between the state and the person taxed [Mullen Brothers v. Maryland, 347 U.S. 340 (1954)], and
2. There must be fair apportionment.

Since these two requirements are the same as two of the four Commerce Clause texts outlined in the Complete Auto Transit four-prong test, the same rationale will hold, and a nonresident professional athlete will not be able to successfully sustain an argument against a state tax based upon a violation of the Due Process Clause.
Equal Protection Clause

A final argument that could be made surrounds the Equal Protection Clause of the constitution, Amendment 14, section 1, which states, in part, that any state shall not deny to any person within its jurisdiction the equal protection of the laws.

In order for a tax to be upheld under an equal protection protest it must:

1. Be for a legitimate state purpose, and

2. Be a tax scheme rationally related to the state purpose.

In the case of a state taxing a nonresident professional athlete, the legitimate state purpose would be to get the individual to pay for the services provided by the state while the individual is earning a portion of the income in that state.

Basing the tax on a percentage of total income based upon games played or days spent in state versus total and subjecting these amounts to the same tax rates, while providing for the allowance of deductions, seems to be rationally related.

An equal protection argument is usually raised when class of individuals is treated differently from another (i.e., corporations as compared to individuals) or when distinctions are made within the same class (i.e., graduated rate structures for federal income tax purposes).

For nonresident professional athletes to make a case they would need to show that either the tax on them or the way it is applied is blatantly discriminatory.

Example 5-1

- If residents of the state are exempt from personal service income performed in the state, yet nonresidents are fully taxed, equal protection is a valid argument.

- If residents are taxed at six percent and allowed deductions to arrive at taxable net income and nonresidents are taxed at twelve percent of gross income, an equal protection argument is valid.

Reciprocity

In examining various state income tax laws, there exists reciprocity or reciprocal agreements. Under these arrangements residents of State A may be exempt from tax on income earned in State B if State A, in turn, exempts income earned by a resident of State B in State A.

- Could an argument be made and sustained that this type of treatment violates State C residents' Equal Protection rights if their income earned in A or B is taxed by that state?
The argument could be made, but doubtfully sustained.

- Is there a valid state purpose for this distinction?

  Yes, it relieves the employers and employees in both contracting states from having to
  withhold taxes and file an extra state tax return.

  This will result in easier compliance and administration.

- Is the taxing scheme rationally related?

  Yes, by not requiring employers to withhold and residents to file, there will be better
  compliance and administration.

Nonresidents of noncontracting states may argue that they are treated differently from nonresidents of
contracting states. This is true but not sufficient to sustain an equal protection argument.

There is not much question today whether or not a state has the right to tax a nonresident professional
athlete on the portion of salary earned by competing in that state. A discussion of some of the key items

to look for when involved in state tax compliance of a professional athlete follows.

**STATE COMPLIANCE**

Every state's law regarding the taxation of individuals is different, and yet very similar.

States that have income taxes on individuals will also tax nonresidents on the portion of their income that
is earned in that state. Nonresident professional athletes are subject to this state tax because state statutes
include as taxable, income derived from the performance of personal services in the state.

**COMPLIANCE STEPS**

1. Check whether client is taxable under resident or nonresident statutes.

2. Next, look at filing requirements.

   - Certain states require filing if any income can be sourced to their state.

     Others will look at amount of gross income allocable to the state.
3. It is also important to see if there are any de minimus exceptions that the individual might qualify for.

Example 5-2:

- Massachusetts does not require nonresidents to file a tax return if their connection with the state is deemed "casual, isolated and inconsequential". The details are in the Massachusetts personal income tax regulations (Reg. 62.5A.1).

The following example is taken from that regulation:

A nonresident professional hockey player plays in all eighty games for his team in 1985 over the parts of two seasons. Four of the games are played in Boston. During each visit to Massachusetts, the player spends one-and-a-half days in the state with the team. This nonresident is considered present for business in Massachusetts for eight days and therefore his presence for business is considered casual, isolated and inconsequential (He failed the 10-day test outlined in regs.-Authors note). He is not considered to be carrying on employment in Massachusetts, regardless of the amount of his salary.

4. In relation to the filing requirements, you also need to check at what level estimated tax payments will need to be made.

5. Check that the individual's home state will allow a tax credit for taxes paid to other jurisdictions.

There may also be reciprocal agreements between the taxpayers' home state and several states they play in. These may eliminate the tax liability owed to that particular state.

Allocation and Apportionment

A final area of concern is allocation and apportionment. Allocation and apportionment is the process by which a state determines how much of an individual's income is sourced to the state and therefore subject to its taxing jurisdiction.

Of the twenty-four states and the District of Columbia that have professional sports franchises (a total of over ninety teams from the NBA, NFL, NHL and MLB), it is the exception rather than the rule for states to have specific guidelines with respect to the allocation of a professional athletes income (resident or nonresident alike). It is, therefore, vital to examine each state's law. For example, New York and California are known to be aggressive taxing jurisdictions.

Missouri's Collector of State Revenue has issued a document (12 CSR 10-2.220) and Massachusetts has a regulation that give details and examples of how to properly allocate a professional athlete's income to those states. They even give details and examples concerning allocation factors (do you just consider
regular season games or does preseason count? and [what about the inclusion or exclusion of bonuses? (both performance and nonperformance based)].

As stated earlier, it is still unclear if any states would end up in a better position if all states were able to enforce their nonresident statutes with respect to professional athletes.

For the meantime, however, states like California and New York will win because of their aggressive approach to tax collection. The burden on the professional athlete will not increase that much from a total tax liability perspective. The increased cost and burden will arise from the increased amount and complexity of tax compliance required.
CHAPTER 5
CASE STUDY 5-1

Directions:

■ Spend about 5 minutes reviewing the case information.
■ Discuss the solutions with the other members of your group.
■ Be prepared to explain the group's solution to the others.
■ Use the space provided for your notes.

Assume:

■ Your client, Bob Flynn, plays for the New York Yankees.
■ Bob, a resident of Maryland, earned $650,000 from the Yankees.
■ Bob played 12 games in California, 6 in Wisconsin, 6 in Minnesota, 6 in Ohio and 6 in Michigan.
■ Bob has retained your firm to help him with his taxes.
■ Prepare an analysis concerning Bob's state income tax responsibilities.

Notes:
Your client, Mark Warren, is a Canadian citizen living in Toronto. Mark is a professional hockey player, currently employed by the Edmonton Oilers.

Mark has retained your firm to help him with his taxes.

Mark has learned that his teammate, Steve Levine (a U.S. resident), has filed a New York State Non-Resident Income Tax Return.

Please advise your client.
Analysis Regarding State Income Tax Responsibilities:

- Prepare a list of the states and cities in which Mr. Flynn resided:

<table>
<thead>
<tr>
<th>STATE</th>
<th>CITY</th>
<th>FROM (DATE)</th>
<th>TO (DATE)</th>
</tr>
</thead>
</table>

- In which state is Mr. Flynn registered to vote?
- In which state is Mr. Flynn's car registered?
- Did Mr. Flynn buy or sell a house during the past year?
- For the allocation of wages to California, use (duty days) 12/220.
- For the Wisconsin allocation (duty days), use 6/190.
- For the Cleveland allocation (duty days), use 6/190.
- For the Michigan allocation, use (games played) 6/190.
- For the New York allocation, use (games played) 81/190.
- For the Minnesota allocation, use (duty days) 6/190.
- Since Mr. Flynn is a resident of Maryland, all of his income is taxable in Maryland. Mr. Flynn can receive a credit in Maryland for his income taxes paid to other jurisdictions.
- Consider new developments in the state income tax area.
The New York adjusted gross income of a nonresident individual includes all items of income, gain, loss, and deductions that enter into the Federal adjusted gross income; limited, however, to the portions of such items derived from or in connection with New York State sources.

Mark is a Canadian citizen who plays approximately 3/8 of his games in the United States. Since Mark's income is exempt from U.S. taxation (treaty with Canada) and is not included in federal adjusted gross income, there is no New York State liability.
APPENDIX

In the Matter of the Petition of KAREEM ABDUL JABBAR for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 1973.

TSB - H - 82 - (76) - I; Income Tax

STATE OF NEW YORK - STATE TAX COMMISSION

1982 N.Y. Tax LEXIS 585

April 30, 1982

[1]

STATE FOR COMMISSION: James H. Tully, Jr., PRESIDENT; Francis R. Koenig, COMMISSIONER; Mark Friedlander, COMMISSIONER

PER CURIAM

DECISION

ISSUES

I. Whether the stipulation and the motion to compel stipulation should be granted in its entirety because of the failure of the Law Bureau to respond in a timely fashion under the State Tax Commission's Rules of Practice and Procedure and whether the response was evasive or not fairly directed to the proposed stipulation.

II. Whether petitioner, [*2] a well-known nonresident professional basketball player, was selectively taxed in violation of the constitutional requirement for equal treatment.

III. Whether the correct method of attribution to New York sources of income received by a nonresident professional basketball player, for his services as a basketball player, is the "days worked" method, the "games played" method, or some other "fair and equitable" method.

IV. Whether $9,500 paid to petitioner pursuant to a written contract, regarding the making of a single on-camera television commercial, should be attributed to income derived from New York sources.
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

FINDINGS OF FACT

1. During 1973, petitioner, Kareem Abdul Jabbar, a well-known professional basketball player, was a resident of Wisconsin and a nonresident of New York.

2. Petitioner filed a New York State income tax nonresident return for 1973. Schedule A of said return reported as petitioner's total "New York State amount," $3,000 for "Wages, salaries, tips, etc.," less "Adjustments" of $62.54, for a "Total New York Income" of $2,937.46. It further reported $2,339.61 as "New York taxable income," subject to tax thereon of $60.19.

3. On April [*3] 11, 1977, the Audit Division issued a Statement of Audit Changes and a Notice of Deficiency against petitioner. These were for personal income tax due for 1973 of $2,350.25, less New York tax withheld of $296.24, or a basic tax of $2,053.61, together with interest thereon of $460.36, for a total amount of $2,513.97. This was done on the ground that petitioner's "Total New York income adjusted" for 1973 was $33,797.50, and that the "New York taxable income adjusted" for said period was $26,934.98.

4. On August 17, 1978, counsel for petitioner caused a proposed stipulation of facts to be served upon the Law Bureau of the Department of Taxation and Finance, pursuant to Section 601.7(a)(1) of the State Tax Commission's Rules of Practice and Procedure.

5. Thereafter, counsel for petitioner made a motion dated November 9, 1978, pursuant to Section 601.7(f)(1) of the Commission's Rules of Practice and Procedure, to compel stipulation or admission of the facts set forth in the proposed stipulation.

6. A reply dated November 28, 1978, to the proposed stipulation was served by the Department's Law Bureau upon counsel for petitioner, who received the same by mail on November [*4] 30, 1978. It was contained in an envelope bearing a machine-metered stamp.

7. Said reply expressed agreement with the items of the proposed stipulation numbered "1," "2," "5a," "6," and "8." In addition, it reduced the basic tax from $2,053.61 to $1,496.29.

8. At the formal hearing held on December 1, 1978, counsel for the Audit Division further limited the items at issue by assenting to item "5c" of the proposed stipulation, thereby leaving for determination the substantive issues described above.

9. (a) It is petitioner's claim that the Audit Division, in violation of the constitutional requirement of equal treatment for taxpayers similarly situated, singled him out and required him to pay a New York tax not required of other nonresident professional athletes.

(b) It is also petitioner's claim that the motivation for so singling him out was that his salary level made it "worthwhile" to require him to pay a New York tax.
10. (a) During 1973, petitioner participated in a total of 82 regular season games as a professional basketball player for the "Milwaukee Bucks," four of which were played in New York. In addition, petitioner's attendance was required at eight pre-season [*5] games and six play-off games, all of which were played outside of New York State.

(b) The Audit Division computed the income that petitioner derived from New York sources during 1973 on the basis of a fraction, the numerator of which was "4" and the denominator of which was "82." This was based on the total number of regular season games which petitioner played during 1973, and the number of games which he played in New York.

11. (a) The total number of petitioner's working days as a professional basketball player for the Milwaukee Bucks during 1973, including pre-season, regular season, play-off games, and practice sessions, at which the petitioner's presence was required by his employer during 1973, was not less than 200. Of those working days, he was present and performing services in New York on six days.

(b) It is petitioner's claim in this proceeding that his New York-source income as a professional basketball player for the Milwaukee Bucks during 1973 should be computed on the basis of a fraction, the numerator of which is the number "6" and the denominator of which is the number "200." This is based on the total number of his paid working days during [*6] 1973, and the number of said working days in New York during the same period.

12. (a) Petitioner entered into a contract with Uniroyal, Inc., dated December 20, 1972. Pursuant to this contract, it was agreed, in part, that petitioner would render "services as an on-camera actor and announcer in connection with the production of one television commercial" on behalf of Uniroyal's "Pro-Keds" sneakers.

(b) Paragraph "8(b)" of this contract further provided that "in the event that the license agreement now being negotiated" between petitioner and Uniroyal, Inc.,

"has now been signed by both parties by March 1, 1973, then the flat sum due you under Subparagraph (a) above shall be increased by ninety-five hundred dollars ($9,500), payable no later than March 10, 1973, so that you shall then have received a total set payment of twelve thousand five hundred dollars ($12,500), plus applicable union scale payments."

(c) Paragraph "5" of said contract dated December 20, 1972, and entitled "Exclusively and Competitive Protection" provided, in part, that:

"During the term hereof, you will not render any service of any kind for or on behalf of, nor will you authorize the use of your [*7] name, photograph, likeness, endorsement, voice, or biographical material to be used in any manner in advertising or publicizing any product or service
STATE INCOME TAX IMPLICATIONS FOR PROFESSIONAL ATHLETES

(hereinafter called "Competitive Product") that competes in any way with Product.

13. The license agreement referred to in paragraph "12(b)" above was not signed by both parties by March 1, 1973.

CONCLUSIONS OF LAW

A. That there is no demonstration in the record of prejudice to the petitioner by reason of the one day's delay in the service of the reply to petitioner's motion to compel stipulation to certain facts. The Civil Practice Law and Rules (CPLR) gives the courts broad discretion to extend time (Section 2004 of the CPLR). The practice and procedure before the Tax Commission is not less liberal. The fact is that the Rules of Practice and Procedure provide that they "shall be liberally construed to secure the just, speedy, and inexpensive determination of every controversy..." (Section 601.0(c) of the Rules of Practice and Procedure).

A one day's delay in the service of a pleading does not commend itself as the basis for the granting of the motion [*8] to compel stipulation on a substantive issue of some importance.

By his argument that the Law Bureau's response was partially evasive and, in effect, constituted agreement with the proposed stipulation petitioner is making what amounts to a motion to dismiss for legal insufficiency. For reasons already stated, this is not an issue which should be disposed of on the basis of technical rules of pleading.

B. That selectivity in taxation is not impermissible, unless based on "improper motivation" (United States v. Kahl, 583 F.2d 1351, 1353). Petitioner has not established the claim of selectivity in view of the absence of evidence in the record to support a finding of fact that he was singled out for taxation for impermissible considerations.

C. That petitioner has not established that claim that he was singled out for taxation by New York in view of the following cases, in each of which a nonresident professional athlete was subjected to New York personal income taxation: Petition of Stephen M. and Starla Thompson, (State Tax Commission, July 20, 1973); Petition of Bobby R. and Kay Murcer, (State Tax Commission, September 22, 1977, involving the years 1971, [*9] 1972 and 1973); and Petition of Roy H. and Linda White, (State Tax Commission, February 14, 1979, involving the tax years 1971 and 1972).

D. That petitioner has not established the claim of selectivity in view of the fact that the New York State revenue system, as well as the Federal tax structure, rely on self-reporting (United States v. Bisceglia, 420 U.S. 141; New York State Department of Taxation and Finance v. New York State Department of Law, Statewide Organized Crime Tax Force, 44 N.Y. 2d 575, 580).

E. That Section 632(c) of the Tax Law provides in part that the portion of income of a nonresident derived from New York sources shall be determined under regulations of the State Tax Commission. Pursuant to 20 NYCRR 131.16, a nonresident employee who performs services for his employer both within and without the state shall include as income derived from New York sources that portion of his total compensation for services rendered as an employee which the total number of working days employed within the state bears to the total number of working days employed within and without the state. 20 NYCRR 131.21 provides:
"Sections 131.13 through 131.20 are designed to [*10] apportion and allocate to this state, in a fair and equitable manner, a nonresident's item of income, gain, loss, and deduction attributable to a business trade, profession, or occupation carried on partly within and partly without this state. Where the methods provided under those sections do not so allocate and apportion those items, the Commission may require a taxpayer to apportion and allocated those items under such method as it shall prescribe as long as the prescribed method results in a fair and equitable apportionment and allocation...."

The allocation of income earned by petitioner as a professional basketball player for his services rendered as such on the basis of days worked within and without New York State during the year does not result in a fair and equitable allocation of income.

F. That in order to result in a fair and equitable apportionment and allocation, under Section 632(c) of the Tax Law and 20 NYCRR 131.21, pre-season, regular season, and play-off games must be included in and allocation ratio used to apportion income based on games played within and without New York State (Roy H. and Linda White, State Tax Commission, February 14, 1979). The record [*11] in this case reveals that in addition to 82 regular season games, the number of exhibition and play-off games in which petitioner was required to participate were eight games and six games respectively. Accordingly, the Audit Division is directed to recompute the allocation ratio on the basis of fraction, the numerator of which is "4" and the denominator of which is "96."

G. That the sum of $9,500 paid to petitioner by Uniroyal, Inc., pursuant to paragraph "8(b)" of the contract between petitioner and Uniroyal, which was dated December 20, 1972, did not constitute income attributable to New York sources.

H. That the petition of Kareem Abdul Jabbar is granted to the extent set forth in Conclusion of Law "E" and "F" and except as so granted the Notice of Deficiency is sustained.
## MASTER LIST OF RECIPROCAL AGREEMENTS

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<th>States Agreement with</th>
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</tr>
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</table>
CHAPTER 6

U.S. TAXATION OF NONRESIDENT ALIEN ATHLETES/ENTERTAINERS AND FOREIGN TAXATION OF U.S. ATHLETES/ENTERTAINERS

OBJECTIVES

- Advise nonresident clients on the various tax implications of performing in and out of the U.S.
- Advise U.S. athletes/entertainers on the tax ramifications of performing in a foreign country.

INTRODUCTION

In today's society, the business of sports and entertainment extends far beyond the borders of the United States. Three of the four major sports have franchises in Canada (football being the exception), and with the creation of the World League of American Football, international athletics is no longer limited to the North American Continent. Many nonresident athletes compete in the United States, and many even play for teams located here. Interesting tax situations arise regarding the sourcing of income and the taxation of certain types of income of a nonresident alien athlete either competing in or playing for a team in the United States.

RESIDENT OR NONRESIDENT

The first consideration athlete/entertainers have regarding a tax situation is whether they are a resident or nonresident alien for income tax purposes. An athlete or entertainer is considered to be a resident of the United States if any of the following requirements are met:

1. The individual is a lawful permanent resident under Sec. 7701(b)(6) of the code (i.e., is in possession of a valid green card).

2. The individual meets a "substantial presence" test whereby he or she is present in the United States for at least 31 days in the current year and a total of 183 days during a three-year period ending with the current year.

For purposes of the 183-day test, only one-third of the days of the taxpayers presence for the immediately preceding calendar year are counted and only one-sixth of the days for the second preceding year are included.
3. "Election Rule"

An individual may elect to be treated as a resident for the portion of the year which he or she is present in the U.S. preceding the year in which he or she first meets the substantial presence test.

4. There may be an income tax treaty between the U.S. and the alien’s country of citizenship which should be consulted since there can be treaty provisions which supersede numbers 1 and 2 above. (It can happen with the U.S.-U.K. treaty fairly often.)

SOURCE OF INCOME

Those athletes deemed to be resident aliens, are treated the same as U.S. citizens and, therefore, are subject to tax on world-wide income. As nonresident aliens, professionals athletes/entertainers are subject to United States federal income tax on the portion of income attributable to performance of services in the U.S. Additionally, they are permitted to deduct a ratable portion of expenses that are related to that income.

ALLOCATION OF INCOME/EXPENSES

How should this income and expense deduction be allocated? Section 861(a)(3) of the Code provides in pertinent part that compensation for services performed in the United States shall be treated as income from sources within the United States. Additionally, Sec. 862(a)(3) provides that compensation for personal services performed outside the United States shall be treated as income from sources without the United States.

Facts and Circumstances

Reg. Sec. 1.861-4(b) provides that if no accurate allocation or segregation of compensation for services performed partly within and partly without the United States can be made:

- Gross income should be determined on the basis that most accurately reflects the income’s source under the particular facts and circumstances.

In many cases, the facts and circumstances will support an allocation on a time basis. That is, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance within the United States bears to the total number of days of performance for which the payment is made.

Other methods of apportionment may be acceptable under different facts and circumstances. In determining the amount of the athlete’s/entertainer’s salary from sources within the United States, it is necessary to determine what consideration is provided by the taxpayer in return for such salary.
In Rev. Rul. 76-66, the IRS concluded that the salary paid to a player under the standard hockey league contract is paid for services performed only during the regular season. Therefore, in accordance with Rev. Rul. 76-66, a nonresident alien athlete would determine United States source income using the following "time basis formula:"

\[
\text{Amount included in U.S. taxable income} = \frac{\text{# of days played in the U.S. during the regular season}}{\text{Total # of days played in the regular season}} \times \text{contract compensation}
\]

Considering the components of this equation, an athlete could reduce the United States tax bill by either spending less time in the U.S. or by showing that the total period for which he was compensated covers the time spent out of the United States (time spent in Canada for off-season and training camp).

This method of calculating U.S. source income was overruled in Stemkowski v. Comm., 690 F2d 40, 1982 and in Favel v. United States, 16 Cl. Ct. 700, 1989.

The Stemkowski Case

- In Stemkowski, petitioner, a nonresident alien from Canada, was a professional hockey player for the N.Y. Rangers.

- The Tax Court held that the total number of days for which Stemkowski was compensated during the year was only 179, the number of days in the regular season.

- Stemkowski claimed on his return that the number of working days was actually 365.

- Stemkowski reasoned that the hockey "year" was divided into four parts:
  
  Training camp,
  
  Regular season,
  
  Play-offs, and
  
  Off-season.
Since he had certain restrictions on him in the off-season, i.e., he was required to physically maintain his body condition during the off-season, his contract was compensating him for the entire year.

The Tax Court based its finding on facts contained in the standard players contract which states that if a player is not in the employ of the club for the entire regular season schedule, then the amount of his yearly salary will bear the same ratio to his total salary as the ratio of total days employed bears to the total number of days in the regular season.

Additionally, the Tax Court deduced from the contract that if a player is suspended, he will not receive that portion of his salary equal to the ratio of the number of days of suspension to the total number of days in the regular season.

In the United States Court of Appeals for the Second Circuit, it was held that both Stemkowski and the Commissioner were incorrect in their respective assessments regarding the period of time for which Stemkowski was compensated.

The Appellate Court agreed with Stemkowski's claim that he was compensated for training camp and play-offs, but rejected his argument that his contract included the off-season.

The Court held that the formulas contained in the players contract for paying part year hockey players and for docking wages due to suspension were not sufficient evidence proving that the player's compensation was only meant for the regular season.

The Court correctly reasoned that this allocation was merely for administrative convenience because days to be spent during the play-offs cannot be known in advance.

Therefore, it would be incorrect to include them in the allocation.

Additionally, owners and league officials have an interest in having the contract cover the shortest possible time span so as to maximize loss to suspended or striking players.

The off-season was held not to be included in the period of a players compensation.

The Court ruled that fitness is not a service performed in fulfillment of the contract but rather a condition of employment.

There was no evidence that Stemkowski was required to follow any mandatory conditioning program or was under any club supervision during the off-season.
The Favel Case

The issue in Favel (which was applicable to five plaintiffs; all nonresident alien professional hockey players with the identical argument) was the same as Stemkowski.

- The court had to determine what portion of the hockey year was covered by the Standard Player's Contract.
- Like Stemkowski, the plaintiff argued that his compensation covered services performed throughout the entire 12-month year.
- This argument was predicated on the plaintiffs' notion that the salary specified in each players contract was paid to fulfill each and every clause in the contract.
- The plaintiffs reasoned that since they were contractually bound by the Standard Player's Contract to do various things during the off-season, i.e.:
  - To achieve a level of physical fitness sufficient to report to training camp in "good physical condition,"
  - To participate in promotional activities, and
  - To refrain from engaging in certain contact sports and improper conduct, they were effectively "on the job" and providing contractual services every day of the year.
- Like the Stemkowski case, the Court of Claims held that although nonresident alien athletes assumed obligations which extended into the off-season, these duties were merely conditions of employment for which no compensation was paid.

Discussion:

- One can argue the Court erred in its decision to exclude the off-season from the period of time covered by the standard player's contract.
  
  Perhaps the correct allocation should be based on a 365-day working year.
- Stemkowski is still under obligation to conduct himself in a manner with loyalty to the team and the league throughout the year.
- He was required to participate in certain off-season promotional events, and he was prohibited from engaging in activities that represent significant danger to his health.
He was not permitted to negotiate with other teams and was required to show up at training camp in good physical condition or incur fine or possible suspension.

Regardless of the Circuit Court's holding that he was not mandated to participate in any physical exercise program during the off-season, the regular physical maintenance of an athlete's body is a necessary and bona fide requirement for his trade or business.

The Gambling Case

Gambling v. Comm., 682 F2d 296, (2d Cir. 1982), determined that when the terms of a written contract are clear and unambiguous, the intent of the parties must be found therein. The Claim's Court concluded in Favel that all the Standard Player's Contracts at issue were clear and unambiguous and subsequently determined that a player is not compensated for the off-season. When considering the rulings in Favel and Stemkowski, it is possible to structure a contract so the athlete achieves victory in international tax planning:

- If a player and his agent so choose, they can negotiate their contract and include written stipulations in the contract stating that the player is being compensated for the entire 12-month year.

- This will not change the amount the player earns (may not change the time of the payments either) but it will lower the amount of United States taxes he owes.

Example 6-1:

- A nonresident alien athlete earns $1,000,000 per year

- He participates in 150 days of training camp, regular season, and play-off games in the U.S.

- He spends another 50 days competing in Canada

Result:

- His allocation to determine U.S. sourced income would be:

\[
\frac{150}{200} \times 1,000,000 = 750,000
\]
Discussion:

- In this case, the athlete would pay U.S. tax on $750,000. However, if the athlete’s contract was structured so as to include off-season days, the time basis formula is lengthened to include 365 days in the denominator.

Thus his U.S. sourced income under this circumstance would be:

\[
\frac{150}{365} \times 1,000,000 = 410,958
\]

Planning Tips:

- Since the court ruled that a player’s contract covers only training camp, the regular season, and play-offs, it must be written into the contract that the player is being compensated for off-season conditioning.

- Other advantages this allocation may produce include:

  Actually lowering the taxes the team has to pay to the U.S. on the players behalf.

  Reducing the amount of state tax an athlete is required to pay.

There are situations where an athlete may benefit from receiving full compensation during the playing season. (thus reducing the denominator of the time basis formula and increasing the U.S. tax). One such instance would be when the athlete is from a home country with a tax rate higher than that of the U.S. It would benefit the athlete to pay Uncle Sam and receive a tax credit from his home country.

WITHHOLDING FOR A NONRESIDENT ALIEN

Section 1441(a) requires all persons having the control, receipt, custody, disposal, or payment of certain items of income from sources within the United States of any nonresident alien to deduct and withhold from such items a tax equal to 30 percent thereof. For purposes of this section, wages are included in the definition of income. Considering that the athletes and entertainers have many expenses to offset income, this provision can be of significant concern to them because of the possibility of over-withholding on income.

This concern is somewhat abated by Reg. Sec. 1.1441-4(b)(3). As outlined in Rev. Proc. 89-47 (discussed in detail below), this section provides that compensation for personal services of a nonresident alien who is engaged during the taxable year in the conduct of a trade or business in the United States
may be wholly or partially exempted from withholding if an agreement is reached between the Director of Foreign Operations District and the alien with respect to the amount of withholding required. The withholding agreement may permit withholding on projected net income at the 30 percent rate or at a graduated rate provided the nonresident alien meets certain requirements. In no case will the withholding agreement reduce the amount of withheld taxes to an amount less than the anticipated income tax liability.

PLANNING WITH REVENUE PROCEDURE 89-47

The I.R.S. has issued a ruling describing a method whereby withholding may be reduced.

As many foreign athletes and entertainers know all too well, the Internal Revenue Code generally requires the withholding of tax at a 30% rate on certain U.S.-source income earned by a nonresident alien. This will be the case unless a reduced rate is provided for by an applicable treaty provision. For many taxpayers, a portion of whose income is properly sourced outside the U.S., the application of this requirement will lead to the withholding of amounts in excess of their ultimate tax liability for the year.

Withholding Rate Agreement

Pursuant to Revenue Procedure 89-47, an opportunity exists whereby a taxpayer may enter into an agreement with the I.R.S. and have the withholding rate established based on a projected tax liability for the year thus minimizing the costs associated with excessive withholding.

In order to enter into such an agreement the taxpayer must agree to:

- File a timely income tax return for the taxable year, and
- Provide the Assistant Commissioner of the IRS with the following information:
  - A list of the names and addresses of the person(s) to be covered by the agreement and copies of all contracts they or their agents have entered into covering the period of the agreement,
  - An itinerary of dates and locations of all performances or events scheduled during the period covered, as well as a proposed budget of gross income and expenses for the period,
  - The name, address, and employer identification number of the person(s) who will be the central withholding agent for the covered alien(s).

After reviewing the information provided, the IRS will prepare a withholding agreement that must be signed by all interested parties. All requests must be in writing at least 90 days prior to their proposed effective date.
Failure to Withhold

A withholding agent is directly liable for the amount of tax he must withhold, together with interest (Section 1461). Civil (100% Section 5572 failure, 5% to 25% negligence) and criminal (Section 7002 up to $10,000 and 5 years imprisonment) penalties may be imposed.

Returns and Payments of Tax

The withholding agent must file with the Office of International Operations (IRS) by March 15, an annual return on Form 1042 of the tax required to be withheld during the preceding year.

Form 1042S is required to be filed in respect of:

1. Items of income upon which tax was required to be withheld.
2. Amounts which, but for a treaty regulation or ruling exemption, would have been required to be withheld.
3. Amount withheld but released by the agent.

Withholding on Signing Bonus

When a nonresident athlete receives a signing bonus from a domestic professional club, certain facts must be determined before the tax implications can be considered.

Two important factors are:

- Whether the bonus is paid to the athlete to provide future services or merely as an inducement not to negotiate with other teams.
- Whether the athlete will be playing games both inside and outside the United States.

Rev. Rul. 58-145 distinguishes between two types of bonuses:

- The first type of bonus is deemed to be an unconditional bonus not predicated on the performance of past, present, or future services but only an incentive to induce the player not to negotiate with other teams.

It was further held that this type of bonus was not subject to Federal withholding tax, FICA, and FUTA because it was not considered to be wages.
The second type of signing bonus discussed in Rev. Rul. 58-145 is predicated upon the performance of future services and therefore considered wages subject to withholding (conditional bonus).

Although a signing bonus for a citizen or resident athlete is exempt from the withholding requirements, Rev. Rul. 74-108 holds that in accordance with section 1441(a) of the code, a flat tax of 30 percent will apply to the portion that is determined to be from sources within the United States (barring any tax treaty). The ruling further states that by virtue of accepting an unconditional signing bonus, the athlete is forfeiting his "right to act" (negotiate with other teams) and therefore an allocation must be made based on the number of places (teams) within and without the U.S. that he forfeited his right to act with.

Example 6-3:

- A nonresident athlete accepts a signing bonus from a United States team.
  - There are ten teams in the league;
    - Five within the U.S. and five without.

Result:

- 50 percent of the athlete's signing bonus will be attributable to U.S. sources.
- It will be subject to the flat withholding tax at 30 percent (barring any provisions of foreign tax treaty).
- The basis upon which a signing bonus is allocated to sources from within and without the United States must be reasonable and based on the facts and circumstances in each case.
- Where a reasonable basis for a sign on fee can't be determined, the entire bonus is deemed to be income from sources within the United States subject to withholding at 30 percent.

ALLOCATION OF BONUSES FOR PLAYOFFS

The IRS has unsuccessfully argued that the athlete's (hockey player) contract compensated him only for the regular season. The IRS argument was built around the fact that when players are engaged in playoff and Stanley Cup games, they receive bonuses therefrom. The Courts have rejected this argument and held that these payments represented prizes and incentives. Additionally, the Courts have determined that playoff bonuses should be allocated separately from the regular season bonus, according to a ratio whose numerator contains the number of days engaged in play-off activity in the United States and whose denominator contains the total number of play-off days engaged in for the entire year.
In conclusion, tax planning for an international athlete is, in part, directly related to the structure of the contract. The bottom line is that several factors will have an effect on income, and the overall picture must be considered when structuring a contract in order to maximize the athlete's tax position.

FOREIGN TAXATION OF U.S. ATHLETES AND ENTERTAINERS

If services are performed in a foreign country, that country may impose tax on the income attributable to those services. Although a foreign tax credit is available in the United States for foreign taxes that do not exceed the U.S. tax on foreign-source income, the foreign tax rate may be higher than the U.S. tax on the same income.

The foreign tax credit is calculated using this formula:

\[
\frac{\text{Foreign Source Income}}{\text{Total Worldwide Income}} \times \text{Tentative U.S. Tax}
\]

The individual should require the employer to reimburse the individual for foreign taxes imposed in excess of U.S. tax liability. This reimbursement is itself subject to U.S. taxation (and perhaps foreign taxation), therefore, there should be a gross-up provision requiring a tax indemnity for U.S. and foreign taxes imposed on the reimbursement payment.

ALLOCATION OF INCOME

Particularly if a tax indemnity cannot be obtained, it is important to reduce foreign taxes to a level that is fully creditable. In some cases, this can be done by allocation of income (subject to reasonableness standards) to:

1. A signing bonus;
2. Preproduction services; or
3. Services in low-tax foreign countries.

These allocations may result in a reduction of foreign-source income, thus reducing the foreign tax credit.
LICENSE PAYMENTS

Another approach to minimize foreign taxes may be to convert some income into license payments. If this is used, the license payments are potentially subject to withholding in foreign countries. However, in most cases, treaties can reduce or eliminate withholding.

Treaties

If the license approach is not used, treaties can reduce foreign taxes. The treaties vary, but there are some generalities:

- Usually, no relief from tax is provided for artists and entertainers.

- Independent contractors are usually exempt if they do not have a permanent establishment, and if they are not present for more than 90 or 183 days.

SUMMARY

Athletes/entertainers are by no means restricted to performing within the United States. And nonresident aliens often perform in the U.S. This creates unique tax problems.

We have covered the tax rules and planning aspects for nonresident aliens performing in the U.S., such as the source of income, saving on withholding, and the allocation of bonuses. Also covered was taxation in foreign countries, and how to minimize these taxes. Techniques such as income conversion and tax indemnities were discussed.
TABLE 6-1
SUMMARY OF RULES

Who is Covered?

IRC Sections 871-878: Nonresident alien individuals. Since trusts, estates, and partnerships are taxed as individuals, these rules cover those nonresident aliens as well.

Exception: Nonresident aliens who are married to U.S. citizens or residents and elect to be treated as residents for joint return purposes will be taxed on worldwide income as if they were U.S. citizens.

How Taxed? Basic Pattern

Classify the income and the taxpayer.

1. **Classify the income.**

   **First:** Classify the income according to source: U.S. or foreign.

   **Second:** Classify the U.S.-source income as income which is, and income which is not "effectively connected with the conduct of a trade or business within the United States." (See discussion below of "effectively connected.")

   The U.S.-source noneffectively connected income can be only these types of income:

   a. Interest, dividends, rents compensation and "other fixed or determinable annual or periodical" income (sometimes referred to as "FDAPI").

   b. In the case of nonresident aliens, but not foreign corporations, gains from distributions from qualified plans.

   c. Gains from sales of certain intangibles (patents, copyrights, trademarks, franchises, etc.) to the extent the payments are contingent on productivity, use, etc. If more than 50% of the payments are so contingent, all the gain is considered this type.

   d. Net capital gains of nonresident alien individuals (but not foreign corporations) present in the U.S. 183 days or more during the taxable year.

   e. All other U.S.
Source income is "effectively connected" [Section 864(c)(3)].

The effectively connected income will be taxed in general, at regular rates, by filing an income tax return. Income classified as (a) through (d) is taxed, in general, at a flat 30% of gross receipts, through withholding.

Third: Classify the foreign-source income as income which is, and income which is not, "effectively connected with the conduct of a trade or business within the United States."

If not effectively connected, the foreign-source income will not be taxed by the U.S.

If effectively connected, it will be taxed only if the foreign taxpayer has an office or other fixed place of business in the U.S.

2. **Classify the taxpayer**

- Not engaged in a U.S. trade or business.

- Engaged in a U.S. trade or business, but having no office or other fixed place of business in the U.S.

- Engaged in a U.S. trade or business and having an office or other fixed place of business in the U.S.
CHAPTER 6

Tax Treatment

Having classified the income and the taxpayer, the tax treatment is summarized as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>1.</th>
<th>2.</th>
<th>3.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No U.S. trade or business</td>
<td>Trade or business but no U.S. office</td>
<td>U.S. Trade or business and office</td>
</tr>
<tr>
<td>U.S.-source &quot;30% income&quot; not effectively connected with U.S. trade or business</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>U.S.-source &quot;30% income&quot; effectively connected with U.S. trade or business</td>
<td>N/A</td>
<td>regular</td>
<td>regular</td>
</tr>
<tr>
<td>Foreign-source income effectively connected with a U.S. trade or business</td>
<td>N/A</td>
<td>not taxed</td>
<td>regular</td>
</tr>
</tbody>
</table>

Fixed Place of Business Requirement

Foreign taxpayers pay tax on foreign-source income only if they are engaged in a U.S. trade or business, and the income is "attributable to" a U.S. office or other fixed place of business.

- **What is an "office or other fixed place of business"?**

  The term is substantially similar to "permanent establishment" in the treaties. It includes the office or other fixed place of certain agents. [Section 864(c)(5)(A)].

- **"Attributable to":**

  Requires that the place be a material factor in the production of the income, and that the place regularly carries on such activities.

  The amount attributable is difficult to arrive at.

  Possibilities: Section 482 rules treaty methods; whatever can be shown to be "proper."
Types of foreign-source income covered - only three classes of such income are considered effectively connected:

- Rents and royalties from intangibles;
- Income from a financial business; and
- Income from the sale of personal property.

Exclusions from gross income

- Compensation of participants in certain exchange or training programs is excluded from gross income of NRS's [Section 872(b)(3)].
- Income exempt under treaty (Section 894(a)).

Permanent Establishment in U.S.

In applying any treaty exemption or reduction of tax with respect to income not effectively connected with the conduct of a U.S. business, a NRA or foreign corporation is deemed not to have a permanent establishment in the U.S. [Section 894(b)]. This gives the treaty benefit to U.S.-source dividends, interest, etc. which constitute investment income even though the taxpayer is engaged in a trade or business in the U.S.

The rule applies even though contrary to a treaty provision (FITA Section 110).

Deductions

Nonresident alien individuals and foreign corporations may only deduct expenses from "effectively connected" income [Section 873(a) and 882(c)].

Deduction is limited to that portion of the expense which is connected with such income. The Regs. provide apportionment and allocation rules.

Exceptions for Nonresident aliens

- Casualty losses of property located in the U.S. [Section 165(c)(3)]
- Charitable contributions (Section 170).
- Also, one personal exemption is allowed a nonresident alien individual.
CHAPTER 6
DISCUSSION QUESTIONS

Directions:

■ Take a few minutes to read over the questions.

■ Be prepared to discuss your responses.

■ Use the space provided for your notes.

1. Discuss the tax consequences of a nonresident athlete performing services for a U.S.-based team.

Notes:
2. Player A, uncertain of his resident status, receives a signing bonus of $200,000 to perform for a U.S.-based hockey team. Discuss the tax consequences to A.

Notes:
3. Player B, a U.S. citizen plays baseball for a Canadian-based team. His salary for the current year will be $900,000. Discuss the allocation of his wages between the U.S. and Canada.

Notes:
CHAPTER 6

SUGGESTED SOLUTIONS — DISCUSSION QUESTIONS

1. Athletes or entertainers who earn income from sources within the United States, but who are citizens of other countries, are also subject to United States tax laws. In a manner similar to U.S. citizens, resident alien athletes/entertainers are taxed on their taxable income from sources both within and outside the U.S. (worldwide income.) However, nonresident alien athletes/entertainers are taxed only on their income earned from sources within the United States.

2. Athletes/entertainers have to determine whether they are a resident or nonresident alien for tax purposes.

An athlete or entertainer is considered to be a resident of the U.S. if any of the following requirements are met:

■ The individual is a lawful permanent resident under 7701(b)(6) (i.e., is in possession of a valid green card).

■ The individual meets a "substantial presence" test whereby he is present in the United States for at least 31 days in the current year and a total of 183 days during the three-year period ending with the current year.

For purposes of the 183-day test, only one-third of the days the taxpayer's presence are counted and only one-sixth of the days for the second preceding year are included.

■ An individual may elect to be treated as a resident for the portion of the year in which he is present in the U.S. preceding the year in which he first meets the substantial presence test.

Once you have determined Player A's resident status, you can begin planning how to minimize the tax liability Player A will incur on the signing bonus.
3. Player B must file both a Canadian income tax return and a U.S. income tax return. Since Player B is a United States citizen, he will be taxed on his entire worldwide income regardless of where it is earned. On his Canadian income tax return, Player B will have to allocate a portion of his wages received from his Canadian employer.

This allocation will be based on a fraction:

- The numerator is the days played in Canada.

  The denominator is the total number of days played during the year.

This fraction will be multiplied by the total contract compensation.

On his U.S. federal income tax return, Player B will be able to take a foreign tax credit for the taxes paid to Canada.

The foreign tax credit limitation will be calculated using the following formula:

- Foreign source income/total worldwide income multiplied by the tentative U.S. tax.
TO: Participants of AICPA Courses

FROM: Dave Dasgupta, AICPA Public Relations/Communications  
(212) 596-6111  
Linda Dunbar, Director of AICPA Public Relations  
(212) 596-6236

RE: Local News Release

The attached news release is a sample of the type of local release that can attract positive attention to your firm, business or educational institution. Your efforts to continue learning in a field that is always changing deserve recognition.

To use this release, simply have it retyped onto your organization's letterhead, using the same basic format as the sample. The contact should be the individual in your organization who most often speaks to the local media.

While the fact that you have been furthering your professional education is the peg on which to hang the story, the local attribution actually gets the story into print. You and your firm, business or educational institution provide the necessary local connection. Therefore, it is important to let news publications know about you, your organization and your company's areas of expertise and operation.

Once your release is retyped on your letterhead, check it for errors, then send it to local papers and business journals. If you have a personal contact at a publication, that individual should receive the release.

If I can provide any further guidance, please don't hesitate to contact me at (212) 596-6111.
FOR IMMEDIATE RELEASE

CONTACT: XXXX XXXXXXXXXX
(XXX) XXX-XXXX

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