ENTERTAINMENT AND SPORTS LAWYER

A PUBLICATION OF THE ABA FORUM ON THE ENTERTAINMENT AND SPORTS INDUSTRIES

Forum on the Entertainment & Sports Industries
AMERICAN BAR ASSOCIATION

...Except Death and Taxes

By Michael Whitaker

INTRODUCTION

Since the Raiders announced their decision to relocate to Las Vegas, there have been multiple articles written stating that the relocation will increase the take home pay of players, coaches, staff and personnel. When recent Raiders' contracts have been reported, much of the focus centered on how those contracts were structured to allow them to take home more money by paying less income tax; however, there has been little discussion as to the reasons why they will pay less income taxes. This article takes an in-depth look at why those players will now pay less in income taxes after the Raiders relocate to Las Vegas, as well as how you may be able to apply these same principles to allow your clients to achieve similar income tax savings.

Overview.

In probably the most famous tax quote ever, Benjamin Franklin declared, "In this world nothing can be said to be certain, except death and taxes." Oliver Wendell Holmes Jr. put it succinctly when he stated that "Taxes are what we pay for a civilized society."

Generally, U.S. citizens pay income tax on their worldwide income, or income earned from sources within and outside the United States. Although U.S. citizens may receive a credit on their U.S. income taxes for taxes paid to a foreign government, they may still owe U.S. income tax on income earned outside of the United States if the income tax rate in the foreign country where the income was earned is less than what the individual would be required to pay if the income had been earned within the United States. This broad power to tax a U.S. citizen on income earned anywhere results in most people paying federal income taxes.

Limitations on a state's authority to impose an income tax.

In addition to federal income taxes, many U.S. Citizens are also required to pay state income tax. Most state income tax laws are based on federal income tax laws, i.e. states tax their residents' income regardless of where it is earned. However, a state's ability to impose tax on individuals is limited by provisions of the U.S. Constitution and by federal statutory law.

One of the most important limitations on a state's ability to tax its residents' income, regardless of where it is earned, and a key distinction between state and federal income tax, is that there must be a close connection or "nexus" between the taxing state and both the taxpayer and the activities that generated the income the state is seeking to tax. Absent a nexus between the taxing state, the taxpayer and the activity that generated the income to be taxed, the state would not have the constitutional authority to levy an income tax on the taxpayer's income. Determining if a nexus exists between the taxing state and the taxpayer becomes the dispositive issue in determining if a state has the authority to impose an income tax on a taxpayer's income. Then the state must determine who it will tax and what types of income it will tax. For example, Arizona, a state that imposes an income tax, does not tax professional baseball players that participate in spring training in Arizona.

Even if a state has the authority to impose an income tax it may choose not to tax certain activities of nonresident taxpayers even if those taxpayers have sufficient nexus to the state that would authorize the state to impose a tax. On the other hand, some states attribute its taxpayer's activity in other states that generate income to the taxing state if the activity to be taxed is connected to employment that originated in the taxing state. For example, a nonresident taxpayer who works for a New York employer must treat days worked outside of New York as New York work days if the taxpayer worked outside of New York for the convenience — as opposed to the necessity — of the employer.[1] This would allow New York to levy an income tax on the activities that occur outside of New York, but that relate back and arise from the taxpayer's employment that originated in New York.

A state must establish a nexus to the taxpayer or activity prior to imposing an income tax.

There are two independent connections that enable a state's imposition of tax on a taxpayer to meet constitutional nexus standards: presence nexus and transactional nexus. Presence nexus requires that a connection exist between the state imposing the tax
and the taxpayer. Presence is based on the two principles of residency or domicile and the source of the income to be taxed. Like the imposition of the federal income tax, the taxpayer's residence or domicile in a state provides that state with a significant connection between the taxpayer and the state. This connection grants the state the authority to tax the resident's income regardless of where it is earned.

The rationale for allowing a state to tax its residents makes sense. A taxpayer who resides in a state enjoying the benefits of the civilized society provided by the state cannot complain if the taxpayer's income is subject to tax that funds the maintenance of the state's civilized society. Therefore, if presence nexus exists, a state may impose an income tax on that taxpayer's income regardless of whether the other independent connection of transactional nexus can be established.

Establishing presence nexus as a resident or domiciliary of a state.

Presence nexus arises from being a resident or domiciliary of a state. For state income tax purposes, states generally designate certain taxpayers as "residents" for personal income tax purposes and taxes them on their worldwide income.

The states' taxing statutes define "resident" in many different ways, but all state's include one or more of the following five concepts when defining a "resident" for state income tax purposes: (1) domicile in the state; (2) presence in the state for other than a temporary or transitory purpose; (3) presence in the state for a specified period of time - either six, seven, or nine months; (4) maintenance of a permanent place of abode or a place of abode for a specified period of time; and (5) a presence in the state for a specified period of time accompanied by the maintenance of a permanent place of abode.[2]

For example, Virginia's definition of a resident includes two classes of residents: a domiciliary resident and an actual resident.[3] An actual resident of Virginia means "a person who, for an aggregate of more than 183 days of the taxable year, maintained his place of abode within Virginia, whether domiciled in Virginia or not." A Virginia domiciliary resident is defined as an individual working outside of Virginia who has not abandoned Virginia residency. A Virginia domiciliary resident continues to be subject to Virginia income tax on the income earned outside of Virginia. Additionally, a person who is not a domiciliary resident of Virginia, but who stays in Virginia for an aggregate of more than 183 days in a calendar year is also subject to Virginia income tax.

Although Virginia's statute defining a resident is cited as an example there is no consistent definition of a "resident" amongst the states, but all definitions include one or more of the five concepts listed above. Frequently, states include several of the five concepts in defining a "resident" so that the state's definition of a "resident" will include as many taxpayers as possible to increase the number of potential taxpayers subject to an income tax and the potential revenue of the state. Most states' definitions of "resident" include domiciliaries.

Many states definition of "resident" also include individuals with various other characteristics in an attempt to classify as many people as possible as a "resident" of that state for income tax purposes. For example, Louisiana defines a "resident" as any individual "domiciled in the State," who "maintains a permanent place of abode within the state" or who "spends . . . more than six months of the taxable year within the state."[4]

North Dakota defines a resident as an individual who is domiciled in North Dakota or an individual who is not domiciled in North Dakota but maintains a permanent place of abode and spends more than seven months of the tax year in North Dakota.[5]

Generally, a state may impose an income tax on all the income of an individual domiciled in the state regardless of where the income is earned. "Domicile" is rarely defined in a state's statutes, but courts and state regulations generally rely on the common law meaning of being the place which an individual intends to be his permanent home, or the place to which an individual intends to return whenever absent.[6] Because the common law definition is also the meaning used for tax purposes, precedents outside of a state's tax statutes and accompanying regulations are relevant in determining a taxpayer's domicile and should be consulted. Domiciliary status in a state is not lost by moving to a different state, unless the individual intends for the different state to become the individual's permanent home.[7]

Because the definition of domiciliary does not require the individual to be present in the state during the taxable year or indicate that the individual has few or no contacts with the state other than an intent to return sometime in the future, some states exempt from resident status domiciliaries who have limited contacts with the taxing state. For example, New Jersey exempts domiciliaries who "maintain no permanent place of abode in this state, maintain a permanent place of abode elsewhere, and spend in the aggregate no more than 30 days of the taxable year in this State."[8] Other states like Arizona and Nebraska include all domiciliaries in their definition of "resident" no matter how limited the domiciliaries' contacts with the taxing state.[9]

The taxpayer's intent is a decisive factor in determining whether any particular residence the taxpayer occupies is his or her domicile.[10] Domicile is not lost until a new one is acquired, and it is presumed to continue until the taxpayer sustains the burden of proving a change.[11] Domicile is not lost merely by personal absence; intent to change domicile is required and the evidence to establish both a change of residence and the required intention to effect a change of domicile must be clear and convincing.[12] Therefore, practitioners need to counsel their clients regarding the affirmative actions to be taken that clearly demonstrate a change of domicile and the records which should be kept in order to support that the affirmative actions to change the individuals domicile have been taken.

The New York Audit Guidelines relating to the determination of domicile are a helpful checklist for practitioners to assist clients in establishing a change of domicile regardless of which state they intend to establish as their domicile. They are:

1. The individual's use and maintenance of a residence in the intended domicile state versus the use and maintenance of a residence not located in the domicile state.
2. An individual's pattern of employment and sources of compensation in the tax year under review.
3. Where an individual actually spends time during the year.
4. The location of an individual's items that hold significant sentimental value, such as family heirlooms, works of art, collectibles, etc.
5. An individual's connections to family.[13]

In addition to the factors noted above in the New York Audit Guidelines, the following additional factors should also be encouraged, and records kept to establish a change of domicile:

1. Active involvement in community, religious, civic or service clubs, fraternal orders and charities;
2. The address used on bank statements, vendor bills, financial data and family business correspondence;
3. The address at which bank statements, bills, financial data are received;
4. The state that issued the individuals driver's license;
5. Where the individual is registered to vote and where the individual has previously voted;
6. Has the individual established a relationship with lawyers, doctors, brokers in the new domicile; and
7. Does the individual's will and other legal documents state that a particular location is to be considered the individual's place of domicile.

Engaging in the listed activities and keeping appropriate records will manifest the individual's intent to establish a new domicile.

The inclusion of nondomiciliaries in a state's definition of resident invites the probability that the same income will be taxed by multiple states under a presence nexus. An individual could qualify as a nondomiciliary resident under a state's resident statute as having a domicile using common law tests in a different state. Because two states could establish a presence nexus, both states would have the constitutional authority to tax the individual's income of regardless of where the income is earned. Therefore, because some states include nondomiciliaries in their tax definitions of residency, an individual's residence in one state does not necessarily prohibit another state from taxing the same income if the other state can also characterize the individual as a resident of its state under its own definition.

This situation can raise Constitutional issues as to whether the definition of "resident" in such instances results in an impermissible imposition of state income tax on an individual and an improper allocation of income to the state. This issue has not yet been addressed by the U.S. Supreme Court. In the context of individuals found to be domiciled in multiple jurisdictions, the Supreme Court has not found a Constitutional bar to an individual being deemed a resident of multiple states under each state's definition of a resident and being taxed as a resident of those states for state income tax purposes.

Establishing a transactional nexus.

The second independent connection is a transactional nexus. A transaction nexus allows a state to impose a tax on a nonresident's personal income arising from sources within that state. The U.S. Supreme Court authorized states to impose a tax on nonresident income arising from sources within a state when it declared, "just as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may … levy a duty of like character, and not more onerous in its effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein."[14] Transactional nexus requires that a connection exist between the state imposing the tax and the property, transaction, or business activity of the taxpayer that generated the income being taxed.

If a transactional nexus exists, even though an individual would not meet the state's definition of a resident, the state still has the authority to impose a tax on the income earned within the taxing state. This rationale also makes sense. A taxpayer who takes advantage of circumstances and enjoys the benefits of the civilized society provided by a state, a state other than the state in which the taxpayer resides, cannot complain when that state imposes an income tax on the income earned within that state. The U.S. Supreme Court similarly stated that “[t]he simple but controlling question is whether the State has given anything for which it can ask return."[15] If a state has somehow contributed, no matter how tangentially, to the income received by a nonresident then the state has the authority to impose a tax on that income.

The independent connection of a transactional nexus is met if the taxpayer's income was earned in a state other than where the taxpayer resides or arises from property located in, or activities taking place in, the other state. Like the issue of nondomiciliaries being included in a state's definition of resident, a transactional nexus can also result in the same income being taxed by multiple states. This result arises because there are two independent connections that allow a state to establish the required nexus empowering the states with the authority to impose an income tax on the income. It is possible that the taxpayer's income will be subject to double taxation by the state where the taxpayer resides under the presence nexus and the state where the income was earned under a transactional nexus.

State income tax challenges faced by professional athletes and entertainers.

Professional athletes, entertainers and all those that travel with them to put on a show face unique tax challenges. These individuals are often residents of one state but spend a significant amount of time in other states earning income.

Most of us have heard that professional athletes are required to pay "jock taxes." These taxes require professional athletes to apportion their income earned between the state where the professional athlete is a resident and any other state where the professional athlete was required by contract to be in the service of the professional athlete’s employer. The nonresident professional athlete must apportion his or her compensation to the state based on the ratio of the “duty days" spent within the state rendering services for the team over the total number of duty days during the year. The term "duty days" includes both official pre-season training and postseason play, as well as other days on which the team member renders services to the team. For non-team athletes like golfers, tennis players, boxers, mixed martial artists and jockeys, states often attribute income to the state on the basis of compensation received for the specific performance or by reference to the ratio of in-state performances to total performances.

The requirement that compensation be apportioned to a state of which the individual is not a resident based on the number of days spent within that the state rendering services for the team over the total number of duty days during the year or amount of compensation received for specific performance to the total number of performances applies to not only the professional athlete, but to all of the employees that travel with the professional athlete or entertainer. This list would include coaches, trainers, equipment managers, scouts, production crew, band members, vocalists, dancers and many others.

Bonuses can also pose a unique challenge. If the bonus is paid for the athlete or entertainer’s services, whether past or future, then the bonus should be apportioned like regular compensation based on the duty days or specific performance formulas described above. If the athlete or entertainer is paid a “signing" bonus, further analysis must be conducted to determine if the bonus is payment for services to be rendered in the future or if the bonus is paid for an intangible right i.e. an exclusivity agreement. If the bonus is payment for services to be rendered, it must be apportioned according to the applicable rules for apportioning compensation. However, if the bonus is payment for an intangible right like a commitment to play for a certain team or a promise to perform at a certain location to exclusion of other locations, then the bonus should not be apportioned but should only be allocated to the state of the athlete’s or entertainer’s residence.

The Federation of Tax Administrators' model apportionment provision adopted by many states provides guidance on how to determine if a bonus should be apportioned like other compensation according to the duty days formula or if the bonus should not be apportioned and should only be taxable in recipient's state of residence as follows:

"[B]onuses" included in "total compensation for services rendered as a member of a professional athletic team" subject to the allocation described in _ this section are:

> (a) bonuses earned as a result of play (i.e., performance bonuses) during the season, including bonuses paid for championship, playoff or "bowl" games played by a team, or for selection to all-

star league or other honorary positions; and

(b) bonuses paid for signing a contract, unless all of the following conditions are met:

(1) the payment of the signing bonus is not conditional upon the signee playing any games for the team, or performing any subsequent services for the team, or even making the team;

(2) the signing bonus is payable separately from the salary and any other compensation; and

(3) the signing bonus is nonrefundable.[16]

This same analysis could be applied to a signing bonus received by an entertainer.

Two myths.

Now that we have a basic understanding of the principles granting states the authority to impose an income tax, we can determine if it is possible to minimize the state income tax burden. There are two myths that need to be dispelled before explaining the strategies to minimize state income tax.

First is the myth that well-compensated individuals like professional athletes, entertainers and others can completely escape paying income tax. There is no strategy or scheme for these types of individuals to eliminate income taxes. Therefore, the goal is to minimize income taxes.

The second myth is that organizing one's affairs to pay the least amount of taxes as *legally* allowed is cheating the system. Judge Learned Hand stated, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[17] "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands."[18] While there is nothing wrong with paying more income tax than is required, there is also no award for paying more than the law requires.

What about those Raiders' contracts.

One specific example that has received significant media coverage is Raiders' quarterback Derek Carr's new deal. ESPN reporter, Darren Rovell, reported that the Raiders' move to Las Vegas was going to save Derek Carr roughly $8.7 million in income taxes.[19] How is Carr saving $8.7 million in income taxes over the life of his contract and how will other Raiders' players, coaches, staff and personnel do likewise? Simply put, by not having to pay California state income taxes.

By 2019 the Raiders will have relocated to Las Vegas, Nevada. Carr is currently a California resident. As such his income is subject to California state income tax. California's current income tax rate for individuals earning over $1 million a year like Carr is thirteen and three-tenths percent (13.3%), the highest rate in the nation. Nevada does not have a state income tax. Once the Raiders relocate to Nevada by 2019, all duty days taking place in Nevada will not be subject to a Nevada state income tax. Additionally, any bonuses earned will not be subject to Nevada state income tax. However, if Carr does not become a Nevada resident, California would still have the authority to impose an income tax on Carr's income. Just because Nevada chooses not to impose a state income tax will not prohibit California from attempting to tax Carr's income if he continues to be a California resident. Carr must take the affirmative steps outlined above to change his domicile from California to Nevada and become a Nevada resident or face potential income tax liability in California.

Unlike Carr, and all the other Raiders' players, coaches, staff and other employees, your clients are most likely not going to be the beneficiaries of a franchise relocating to Nevada or one of the other states that do not impose an income tax. So, what can you do to minimize their state income tax burdens?

Relocate to a state with a lower tax rate.

If relocating is an option, changing the taxpayer's domicile to a state with a lower or no state income tax is an effective method. Not all state income tax rates are as high as California's. For tax year 2018, for states that impose an income tax the top state marginal individual income tax rates will range from a high of thirteen and three-tenths percent (13.3%) in California, to a low of two and nine-tenths percent (2.9%) in North Dakota.[20]

Additionally, including Nevada, there are seven states that do not tax income earned as wage or salary. Those states are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. New Hampshire and Tennessee exclusively tax dividend and interest income.[21] Tennessee is currently phasing out its income tax applied only to dividends and interest income and is scheduled to repeal its income tax entirely by 2022.[22] Relocating to a state with a lower income tax rate or no state income tax is an effective method to decrease taxes imposed under a presence nexus. This option will not prevent states with a transactional nexus to the income from taxing income earned in that state, but it will effectively decrease the amount of state income taxes paid in the resident state.

Establish a trust in a state without an income tax.

If relocating is not an option, establishing a non-grant- or trust in a state without an income tax is another potential option to reduce income taxes. While this option would apply only to the income generated by the trust, and not the income used to fund the trust, it is an effective method to increase invested wealth by not having the state income tax eat into the investment returns. It may be possible to transfer intangible rights to the trust so that any income received by the trust as a bonus for the intangible right would not be subject to state income tax.

For purposes of taxing the income generated by a trust, many states follow the same significant connection rules that apply to individuals. First, a state desiring to impose a state income tax on the income generated by a trust must determine if the trust is a resident or nonresident of the state. Resident trusts, like resident individuals, are taxable on all their income from whatever source derived; nonresident trusts, like nonresident individuals, are taxed only on income derived from sources within the state. Therefore, like an individual, a state must establish either presence nexus or transactional nexus to have the authority to impose a state income tax on the income generated by a trust.

Trusts are unique in that the residence of a trust can be determined at the time it is created. A trust whose governing instrument expressly states that the trust is to be governed by the laws of a specific state, is administered in that state and the trustee is a resident of that state will in most cases be a resident of that state for income tax purposes. This allows an individual to take advantage of the state income tax savings benefit offered by a state without an income tax.

Not all trusts will qualify for state income tax savings. The federal tax laws and many state tax laws governing trusts will disregard the trust as a "grantor" trust if the settlor of the trust retains certain powers or controls over the trust or its investments.[23] A detailed discussion of the grantor trust rules is beyond the scope of this article. What is important to note is that it is possible to structure a trust as a "non-grantor" trust that will be treated as a separate taxpayer independent of its settlor and this separate taxpayer can qualify for state income tax savings.

Thus, income earned by a non-grantor trust whose assets, trustee and administration occur in a state that does not impose an income tax like Nevada may not be subject to an income tax.

CONCLUSION

States gain the authority to impose an income tax through the establishment of a presence nexus or a transactional nexus. By understanding these concepts and counseling your clients on a proper course of implementation, it may be possible to minimize or even eliminate your client's state income tax burdens.

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Endnotes

1. N.Y. Comp. Codes R. & Regs. tit. 20 § 132.18(a); Zelinsky v. Tax App. Trib., 801 N.E.2d 840 (2003), cert. denied, 541 U.S. 1009 (2004).
2. *See* Altman & Keesling, Allocation of Income in State Taxation 43 (2d ed. 1950).
3. Va. Code Ann. §58.1-302.
4. La. Stat. Ann. § 47:31.
5. N.D. Cent. Code Ann. § 57-38-01 (West).
6. State v. Garford Trucking, Inc., 72 A.2d 851, 855 (1950) (the basic concept underlying domicile is that of home); Cal. Code Regs. tit. 18, § 17014(c).
7. *See, e.g.*, White v. Stowell, 119 N.E. 121 (1918) (a domicile once acquired is not lost until a new one is obtained).
8. N.J. Rev. Stat. § 54A:1-2(m)(1).
9. Ariz. Rev. Stat. Ann. § 43-104(19)(b); Neb. Rev. Stat. §77-2714.01(7).
10. *See* New York TSB-A-00(3)I (May 31, 2000).
11. Lawrence v. Mississippi Tax Comm., 286 U.S. 276 (1932).
12. *In re* Wilkinson, No. 191228 (Cal. State Bd. of Equal. Oct. 15, 2003) (California properly imposed tax on a taxpayer that was working overseas because the taxpayer did not prove that he did not intend to return to California upon termination of his assignment or that he severed his ties with the state during his assignment).
13. *See* Matter of Clay and Rita Buzzard, No. 808865 (N.Y. Tax App. Trib. Feb. 18, 1993) (no change of domicile from New York because of the taxpayer's expressed commitment to spending as much time in New York with their family, and their expressed commitment to continue business and social activities in the state). *But see* U.S. v. Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000) (Minnesota cannot presume that Public Health Service officers are domiciled in the state solely because their spouses are deemed to be, however, the state may consider other factors as indicative of domicile without running afoul of federal legislation).
14. Shaffer v. Carter, 252 US 37, 52, 40 S. Ct. 221 (1920).
15. Wisconsin v. JC Penney Co., 311 US 435, 444, 61 S. Ct. 246 (1940).
16. NY Comp. Codes R. & Regs. tit. 20, § 132.22 (Westlaw 2017).

See also Dishman v. Wisconsin Dep't of Revenue, No. 04-I-

24, Wis. Tax App. Comm'n, May 24, 2005, *available at* www. checkpoint.thomsonreuters.com (signing bonus constitutes part of apportionable compensation under model apportionment provision, which was adopted by Wisconsin).
17. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).
18. C.I.R. v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, L., dissenting).

19. Darren Rovell, *Raiders move to Las Vegas will save Derek Carr $8.7 million taxes*, http://www.espn.com/nf/story/_/ id/19845375/the-oakland-raiders-moving-las-vegas-save-quarterback-derek-carr-upwards-87-million-taxes-2017-nf (last visited May 11, 2018);

20. Tax Foundation, https://taxfoundation.org/state-individual- income-tax-rates-brackets-2018/ (last visited May 11, 2018).
21. *Id*.

22. Tennessee Department of Revenue, Hall Income Tax Notice, July 2016, https://www.tn.gov/content/dam/tn/revenue/documents/ notices/income/16-05Hall.pdf.
23. I.R.C. §§ 671 -678.