

State Taxation of Deferred Compensation Paid to Athletes

By James K. Smith and Taryn Smith*



Shohei Ohtani has been in the news quite a bit over the last six months. He signed a controversial record-breaking \$700 million dollar contract with the Los Angeles Dodgers (Dodgers) in December of 2023, had a secret marriage in February of 2024,¹ and then became embroiled in a betting scandal with his Dodger interpreter in March of 2024.² Perhaps his marriage and the betting scandal will take the heat away from some of the controversial state tax aspects of his contract, but this is unlikely. The \$700 million 10-year contract pays Ohtani \$2 million per year for the first 10 years of the contract and then \$68 million per year in deferred income for years 11–20. The state tax controversy centers around whether Ohtani will have to pay California income taxes on the \$680 million of deferred income in years 11–20, if he no longer resides in California. The contract is structured to take advantage of a federal statute,³ which prevents states from taxing nonresidents on retirement income.

Ohtani is not the only Dodger on the roster with significant amounts of deferred income. Four other Dodgers have substantial amounts of deferred income incorporated into their contracts. The payouts on these five contracts are shown in Table 1. First baseman Freddie Freeman signed a \$162 million six-year contract in 2024, with \$57 million of deferred income.⁴ Catcher Will Smith signed a \$140 million 10-year contract in 2024, with \$50 million of deferred income.⁵ Outfielder Teoscar Hernandez signed a one-year \$23.5 million contract in 2024, with \$8.5 million of deferred income.⁶ Finally, Shortstop Mookie Betts signed a \$365 million 12-year contract in 2021, with \$120 million of deferred income. The deferred income in Ohtani's contract, plus the deferred income in the other four contracts, totals \$915.5 million, close to \$1 billion dollars. The sheer magnitude of these deferred contracts is best understood when comparing them to the total payroll of other major league baseball (MLB) teams. The total of the average annual salaries for just these five Dodger contracts equals \$164,916,667 (see Table 2), which is more than the total payroll for the entire rosters (38–40 players) of 15 of the 30 MLB teams.⁷

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TABLE 1.¹

	Shohei Ohtani	Freddie Freeman	Will Smith	Teoscar Hernandez	Mookie Betts
Current Salary (\$)					
2021					14,500,000
2022					14,500,000
2023					17,000,000
2024	2,000,000	20,000,000	23,550,000	15,000,000	22,000,000
2025	2,000,000	20,000,000	23,000,000		22,000,000
2026	2,000,000	20,000,000	8,000,000		20,000,000
2027	2,000,000	15,000,000	8,000,000		20,000,000
2028	2,000,000	15,000,000	4,500,000		24,000,000
2029	2,000,000	15,000,000	4,500,000		24,000,000
2030	2,000,000		4,500,000		24,000,000
2031	2,000,000		4,500,000		21,500,000
2032	2,000,000		4,500,000		21,500,000
2033	2,000,000		4,950,000		
Total Current (\$)	<u>20,000,000</u>	<u>105,000,000</u>	<u>90,000,000</u>	<u>15,000,000</u>	<u>245,000,000</u>
Deferred Salary (\$)					
2028		4,000,000			
2029		4,000,000			
2030		4,000,000		850,000	
2031		4,000,000		850,000	
2032		4,000,000		850,000	
2033		4,000,000		850,000	10,000,000
2034	68,000,000	4,000,000	5,000,000	850,000	10,000,000
2035	68,000,000	4,000,000	5,000,000	850,000	9,000,000
2036	68,000,000	5,000,000	5,000,000	850,000	8,000,000
2037	68,000,000	5,000,000	5,000,000	850,000	8,000,000
2038	68,000,000	5,000,000	5,000,000	850,000	10,000,000
2039	68,000,000	5,000,000	5,000,000	850,000	10,000,000
2040	68,000,000	5,000,000	5,000,000		11,000,000
2041	68,000,000		5,000,000		11,000,000
2042	68,000,000		5,000,000		11,000,000
2043	68,000,000		5,000,000		11,000,000
2044					11,000,000
Total Deferred (\$)	<u>680,000,000</u>	<u>57,000,000</u>	<u>50,000,000</u>	<u>8,500,000</u>	<u>120,000,000</u>
Total Salary (\$)	<u>700,000,000</u>	<u>162,000,000</u>	<u>140,000,000</u>	<u>23,500,000</u>	<u>365,000,000</u>

¹ "MLB Team Payroll Tracker," MLB, Team Payrolls, Spotrac.com April 5, 2024.

The primary reason for deferring such a large amount of player salaries is so that the Dodgers can avoid paying the Competitive Balance Tax (CBT) (luxury tax), which kicks in for 2024 when the total salaries for an MLB club's roster exceeds \$237 million (salary cap).⁸ The Dodgers have the second-largest estimated MLB payroll for 2024 at \$324,236,435, which is \$87,236,435 over the salary cap

and is estimated to trigger a luxury tax of \$71,360,079.⁹ Deferring large portions of their stars' salaries allows the Dodgers to sign other quality players and avoid paying additional amounts of the luxury tax. Ohtani specifically indicated this was a key reason for structuring his contract with substantial amounts of deferred income. He said he would "defer as much money as I can, if that's going to

TABLE 2.

	Total Payments (\$)	Length in Years	Average Annual Salary (\$)
Shohei Ohtani	700,000,000	10	70,000,000
Freddie Freeman	162,000,000	6	27,000,000
Wil Smith	140,000,000	10	14,000,000
Teoscar Hernandez	23,500,000	1	23,500,000
Mookie Betts	365,000,000	12	30,416,667
Total			<u>164,916,667</u>

help the CBT. That's going to help the Dodgers be able to sign better players and make a better team.”¹⁰ To the extent these players can avoid California income taxes on the deferred portions of their contracts is an added incentive. This is particularly true with Teoscar Hernandez, who signed a one-year contract with \$8.5 million deferred. He will play for one-year with the Dodgers and will not start receiving deferred income until the year 2030, when he is turning 38 years of age. It is likely that he will retire and return to his home state of Florida at this point, which does not have a state income tax.¹¹

Numerous state tax issues are presented by these deferred contracts. The first is whether these deferred contracts fit within the exception provided by the federal statute 4 USC §114.¹² California clearly is not in favor of this interpretation but will have a tough time imposing an income tax on contracts properly structured to take advantage of USC §114. Since the players in question compete in states outside of California, these outside states have a right to tax a portion of the players' current salaries (*i.e.*, jock tax) and might also be interested in taxing a portion of their deferred salaries. The five deferred Dodger contracts are all structured differently, and it is not clear if all five of the contracts meet the requirements of USC §114. State payroll taxes, such as California's state disability insurance (SDI) tax, might be due on a portion of the deferred income in the year the services are provided. This might result in large amounts of SDI taxes during the early years of these contracts.

Title 4, U.S. Code §114 Limitation on State Income Taxation of Certain Pension Income

USC §114(a) says that “no state may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such state.” Retirement income under this statute is broadly defined to include most traditional pension plans, but also includes under USC §114(b)(1)(I), “any plan, program, or arrangement

described in Code Sec. 3121(v)(2)(C) ... if such income is part of a series of substantially equal periodic payments (not less frequently than annually) ... made for a period of not less than 10 years.” Code Sec. 3121(v)(2)(C) refers to nonqualified deferred compensation (NQDC) plans, such as the deferred payments made to the five Dodgers. USC §114 opens the door for NQDC plans to get the same beneficial state tax treatment as traditional pension plans. Ohtani's NQDC plan of \$68 million per year for 10 years (years 11–20 of his contract) appears to be designed specifically to fit within the USC §114(b)(1)(I) exception to state taxation. So, if Ohtani plays 10 years for the Dodgers and then moves outside of California, he will avoid California income taxes on \$680 million of deferred compensation. Assuming Ohtani is in the top California income tax bracket of 14.4%, this could result in Ohtani escaping close to \$98 million in California income taxes ($14.4\% \times \$680$ million). Ohtani will be turning 39 in the year he starts to receive the deferred compensation, so his retirement outside of California is a distinct possibility.

According to the House Report 104-389, written to explain and justify USC §114, there are numerous reasons to prohibit state taxation of retirement income of nonresidents. Although the report acknowledges states have the right to tax nonresidents on deferred income earned (sourced) in the state, it indicates this is unfair. Ironically, HR 104-39 singles out California by stating, “One state in particular, California, has aggressively sought to tax annuity payments made to retirees who have moved elsewhere.” HR 104-39 considered this unfair because nonresident retirees have no right to vote in the state they have moved out of and “receive no current benefit from their tax payments.” In addition, the record-keeping requirements imposed on nonresident retirees on their retirement account histories would be “enormous and perhaps unmanageable.” Taxing some retirees, but not others, would also create an unfair state tax system. California acquiesced to USC §114 by adopting CA Rev. & Tax Code §17952.5, which uses the same language as USC §114.

Despite states acquiescing to USC §114, there can be issues regarding whether certain NQDC plans meet the requirements of this code section. For NQDC plans to qualify under USC §114, there must be an “income tax” that is being imposed on a series of “substantially equal periodic payments” over a period of “not less than 10 years.” USC §114 defines an “income tax” by using the definition given in IRC 4 USC §110(c), which defines an income tax as “any tax levied on, with respect to, or measured by, net income, gross income, or gross receipts.” This would appear to include both state income taxes and state payroll taxes. All five of the Dodger contracts require deferred payments over 10 or more years, which clearly meet the requirement of a period of “not less than 10 years.” However, two of the contracts might violate the requirement of the deferred income being a series of “substantially equal periodic payments.” While the Ohtani, Smith, and Hernandez contracts all provide for equal payments over a 10-year deferral period, both Freeman’s and Bett’s contracts have unequal amounts in the deferral period. Freeman’s contract provides for \$4 million per year during the first 8 years of the deferral period (years 2028–2035) and then \$5 million per year in the final 5 years of the deferral (years 2036–2040). Bett’s contract has varying deferral amounts over a 12-year period: \$8 million (years 2036–2037), \$9 million (year 2035), \$10 million (years 2033–2034 and years 2038–2039), and \$11 million (years 2040–2044). It is not clear why these contracts were drafted to run afoul of this rule. It might be that the players plan to remain in California after playing or were just not aware of the rule requiring equal payments.

California might have to produce alternative solutions to taxing the deferred income of athletes. With close to \$1 billion in deferred income on just five Dodger contracts, this problem is likely to only get more pronounced.

USC §114 does not define the term “substantially equal periodic payments.” However, Code Sec. 402(c)(4)(A) uses the exact phrase “substantially equal periodic payments” for purposes of distributions from defined contribution

plans. Under this code section, unequal amounts paid out using the declining balance method are allowable,¹³ which shows there is some flexibility in the definition of this phrase. This need for flexibility regarding the definition of “substantially equal periodic payments” led to an amendment to USC §114 in the year 2006, which allows for adjustments “from time to time ... to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the period payments ... to fail the ‘substantially equal periodic payments’ test.”¹⁴ The unequal amounts of deferred income under the contracts for Freeman and Betts do not appear to fit into these exceptions. As a result, California might have an opening to tax the deferred income in the years the players receive it, even if they are nonresidents at that point in time.

Payroll Taxes

While the deferred income in the Dodger contracts has a favorable outcome for purposes of the California personal income tax, the results are not as clear regarding payroll taxes. California has an SDI tax equal to 1.1% of an employee’s salary, which is paid through employer withholding. Unfortunately for Ohtani, California Senate Bill 951 greatly increased the SDI tax for years beginning in 2024. The new law increases the SDI tax rate to 1.1% (0.9% in 2023) and eliminates the wage limit (\$153,164 in 2023) on which the tax is imposed. So, instead of paying only \$1,378.48 under the 2023 rules ($0.9\% \times 153,164$), Ohtani will owe a much larger SDI tax. If he only pays SDI tax on his current \$2 million salary, he will owe an annual SDI tax of \$22,000 ($1.1\% \times \2 million) for the first 10 years of his contract. If California attempts to also impose the SDI tax on his \$68 million of deferred income in the year the services are provided, he will likely be taxed on the present value (PV) of the \$68 million.¹⁵ MLB currently uses a 4.43% discount rate for valuing deferred payments for purposes of its salary cap, which results in a PV of \$44.08 million for the \$68 million of deferred income.¹⁶ If the state uses a number close to \$44.08 million as the PV of the deferred income, Ohtani might owe an annual SDI tax of approximately \$506,880 ($1.1\% \times \46.08 million) for each of the first 10 years of his contract.

According to the Employment Development Department (EDD) of California and the California Unemployment Insurance Code (UIC) §928.5, wages subject to SDI withholding include employer contributions to NQDC plans at the later of (1) when the services

are performed or (2) when there is no substantial risk of forfeiture to the right to the deferred compensation. Assuming there is no credible risk of forfeiture in Ohtani's contract, this results in his owing SDI tax on \$46.08 million (*i.e.*, \$2 million salary plus the \$44.08 million PV of his deferred salary of \$68 million) for each of the first 10 years of his contract. However, if Ohtani's \$68 million deferred income is viewed as being subject to a substantial risk of forfeiture, this might postpone the SDI tax on the deferred income until a later year. If this is the case, Ohtani might escape the SDI tax on the deferred income through USC §114, which negates an "income tax" on properly structured deferred income plans. As mentioned above, SDI tax is likely to meet the definition of an income tax under USC §114(b)(2). This also requires Ohtani to move outside of California in year 11 of the contract.

The rules for subjecting deferred income to California's SDI tax are the same rules used for Federal Insurance Contribution Act (FICA) taxes. Much like the SDI tax, the FICA tax on Medicare does not have a wage cap. So, the question is how much income is subject to the FICA Medicare tax in the year services are provided. Code Sec. 3121(v)(2) states that FICA taxes are due on NQDC plans at the later of (1) when the services are performed or (2) when there is not substantial risk of forfeiture of the rights to the deferred income. Assuming there is not a credible risk of forfeiture to the deferred income, this requires Ohtani to pay FICA taxes on deferred income in the year the services are provided. In this case, the FICA taxes are due on his current \$2 million salary, plus on the PV of the deferred \$68 million payment.¹⁷ As shown above with the SDI tax, MLB's calculation resulting in a PV of \$44.08 million for the \$68 million in deferred compensation allows for a good estimate of potential FICA taxes due. This results in Ohtani paying annual FICA Medicare taxes on \$46.08 million of income, which results in \$1,080,630

in annual FICA Medicare taxes.¹⁸ If only \$2,000,000 of Ohtani's compensation is subject to FICA Medicare taxes, he will owe \$44,750 in tax.¹⁹ Once again, whether there is a substantial risk of forfeiture will determine if the PV of the deferred income is subject to FICA Medicare taxes in the year the services are provided.

Assuming the worst-case scenario for Ohtani on the payroll taxes, he might owe more in annual taxes than his actual \$2 million annual salary. Table 3 shows that the total amount of Ohtani's annual Federal and California taxes might be as high as \$2,625,963, depending on several factors. The primary factor is whether California and the Federal government subject the PV of his \$68 million in deferred income (estimated to be \$44.08 million) to payroll taxes in the year the services are provided. This might happen if his deferred salary is not subject to a substantial risk of forfeiture. Other factors influencing total taxes due include changes in the tax rates (*e.g.*, Federal tax rate might increase back to 39.6%) and changes in various other tax rules (*e.g.*, cost of living (COL) adjustments on FICA).

Possible Solutions

The Dodger's massive, deferred contracts has spurred talk of rule changes for both the MLB competitive balance tax (salary cap)²⁰ and for state income tax purposes. California Controller Malia M. Cohen asked Congress to make changes to USC §114 to make it fairer. Cohen said, "The current tax system allows for unlimited deferrals for those fortunate enough to be in the highest tax brackets, creating a significant imbalance in the tax structure. The absence of reasonable caps on deferral for the wealthiest individuals exacerbates income inequality and hinders the fair distribution of taxes."²¹ Placing a cap on the amount of deferred income that escapes state income taxation is clearly a reference to the enormous

TABLE 3.

Ohtani's Annual Tax (\$):	Tax (\$)	Tax Rate	Amount Taxed (\$) ¹
SDI Tax	506,880	1.10%	46,080,000
California Income Tax	288,000	14.40%	2,000,000
Federal Income Tax	740,000	37.00%	2,000,000
FICA: Social Security	10,453	6.20%	168,600
FICA: Medicare Tax	3,625	1.45%	250,000
FICA: Additional Medicare Tax	1,077,005	2.35%	45,830,000
Total Taxes	2,625,963		

¹ SDI tax and FICA Medicare tax might be imposed on a total of \$46.08 million: \$2 million in current salary + \$44.08 million (PV of \$68 million of deferred salary).

amounts of income deferred under the Dodger's various deferred contracts. Whether Congress is inclined to intercede in this area appears to be unlikely. States pleaded with Congress to address the U.S. Supreme Court "physical presence" nexus standard for the sales tax (*e.g.*, Marketplace Fairness Act of 2013), but none of the bills introduced were successful.²² This resulted in the U.S. Supreme Court making a rule change allowing for "economic presence" for sales tax purposes in 2018.²³ Prior to this rule change, frustrated states tried various alternative methods to tax remote sellers, such as affiliate nexus and agency nexus. California will need to be imaginative and look for alternative ways to tax the deferred income of wealthy taxpayers.

Conclusion

Ohtani's contract with the Dodgers has attracted a lot of attention regarding the possibility of state income tax avoidance on \$680 million of his deferred income. His contract was cleverly structured to take advantage of USC §114, which disallows states from imposing an income tax on the retirement income of nonresidents. Ohtani's deferred income of \$68 million per year for years 11–20 of his contract appears to meet the NQDC plan requirements of USC §114(b)(1)(I), which allows him to avoid California state income tax if he is a nonresident in the

years he receives his deferred income. The four contracts for Will Smith, Teoscar Hernandez, Mookie Betts, and Freddie Freeman also have enormous amounts of deferred income. While these significant amounts of deferred income help the Dodgers avoid paying the luxury tax to MLB, they also possibly help the players avoid paying state income taxes. The contracts for Smith and Hernandez appear to be properly structured to avoid state income taxes under USC §114, but the contracts for Betts and Freeman might not get this treatment because the deferred payments in these contracts are not "substantially equal periodic payments." All five deferred contracts might have problems with California's SDI tax if California subjects the PV of the deferred payments to SDI tax in the year the services are provided. This is likely to be the case unless the deferred payments are subject to a substantial risk of forfeiture. The state tax outcome also depends on how aggressive California is in attempting to tax the deferred income. California is typically one of the more aggressive states in asserting its tax rights, so it is unlikely that the Franchise Tax Board will be passive. Possible solutions include Federal intervention, but this appears to be unlikely to happen. California might have to produce alternative solutions to taxing the deferred income of athletes. With close to \$1 billion in deferred income on just five Dodger contracts, this problem is likely to only get more pronounced.

ENDNOTES

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¹ "Shohei Ohtani's Wife Identified as Former Pro Basketball Player After Dodgers Star Revealed Secret Marriage," *CBSSports.com*, March 14, 2024.

² *Gambling Scandal Shines Light on Shohei Ohtani's Odd Financial Decisions*, *WALL STREET J.*, March 27, 2024.

³ 4, USC §114.

⁴ "Details of Will Smith's 10-Year Dodgers Contract, Including \$50 Million in Deferrals," *TrueBlueLA.com*, March 28, 2024.

⁵ "More Deferred Money in Smith's L.A. Contract," *The San Diego Union Tribune*, March 29, 2024.

⁶ "Report: Dodgers Signing Former Allstar OF Teoscar Hernandez to a 23.5M Contract, Some of Which Will be Deferred," *Yahoo!Sports* January 7, 2024.

⁷ "MLB Team Payroll Tracker," *MLB, Team Payrolls, Spotrac.com* April 5, 2024.

⁸ "Why the Dodgers Have Made Salary Deferrals a Common Part of Contract Negotiations," *The Athletic*, March 27, 2024.

⁹ "MLB Team Luxury Tax Tracker," *MLB, Tax Payrolls, Spotrac.com* April 5, 2024.

¹⁰ "Why the Dodgers Have Made Salary Deferrals a common part of Contract Negotiations," *The Athletic*, March 27, 2024.

¹¹ *Id.*

¹² USC §114.

¹³ Proposed Reg. §1.402(c)-2(d)(4)(i).

¹⁴ This language is added to USC §114(b)(1)(i)(ii).

¹⁵ California is likely to piggy-back on the federal rule contained in Reg. §31.3121(v)(2)(i), which requires FICA taxes to be paid on the PV of deferred income.

¹⁶ "Sho' Money, Sho' Problems: What Ohtani's Contract Can Teach Us About Discount Rates," *Pivotal189.com*, January 3, 2024.

¹⁷ California is likely to piggyback on the federal rules, which requires FICA taxes to be paid on the PV of deferred income under Reg. §31.3121(v)(2)(i).

¹⁸ FICA Medicare tax is imposed on current salary of \$2 million + PV of 44.08 million = total \$46.08 million. The resulting FICA Medicare

tax = (250,000 × 1.45%) + (45,830,000 × 2.35%) = \$1,080,630.

¹⁹ FICA Medicare tax on \$2 million = (250,000 × 1.45%) + (1,750,000 × 2.35%) = \$44,750.

²⁰ *Shohei Ohtani's Dodgers Move Sparks Luxury Tax Reform Talks*, *VANDERBILT J. ENTERTAINMENT TECHNOLOGY LAW*, January 26, 2024.

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²² "Will Congress Take on Remote Sales Tax in 2019?" *January 9, 2019, Avalara.com*.

²³ *South Dakota v. Wayfair, Inc.*, SCt, 585 US __, 138 SCt 2080 (2018).

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