NQDC Plans: State Source Taxes

By Matt Maier for PSCA's NQDC committee, originally published in the Spring 2024 edition of Insights

It's relatively rare that my passion for baseball and my "day job" ever cross paths. Sadly, my childhood dream of playing third base for the Chicago Cubs ended many years ago. For the past 20 plus years, I've advised companies on the design and operation of their deferred compensation programs. For the most part, these are two extremely different worlds. However, this past December these worlds did in fact meet when the Los Angeles Dodgers signed Shohei Ohtani to a 10-year, $700 million contract.

As a global superstar, Mr. Ohtani earns millions of dollars in endorsement agreements in addition to his lucrative contract with the Dodgers. Astutely, the Dodgers and Mr. Ohtani's agent leveraged his fortunate position and structured his contract to pay him $2 million per year during his playing years with the remaining $680 million payable to him over the subsequent 10 years.

By structuring his contract in this manner, the Dodgers can keep their annual payroll down (subjectively) and Mr. Ohtani is able to lower his annual taxable income. Also, by having his deferred compensation payable over at least ten years, Mr. Ohtani could choose to utilize a special tax treatment commonly referred to as source tax tracking. This is a tax treatment that, assuming he meets specific eligibility, Mr. Ohtani could use and avoid paying California state tax if he were to subsequently leave the state when his contract is over.

This strategy isn't a new novel idea. Companies have been using deferred compensation plans for decades to help recruit and retain some of their key talent. This strategy is also not new to baseball. In 2000, the NY Mets cut ties with the aging superstar Bobby Bonilla and utilized a deferred compensation program to spread out the remaining amount owed to him under his contract. Each July 1st, Mr. Bonilla receives $1.2 million from the Mets, payable until 2035. July 1st has affectionately become known as "Bobby Bonilla Day."

Deferred compensation programs are contractual arrangements where a portion of an athlete or executive's compensation is paid out at a later date, typically after retirement. For athletes like Mr. Ohtani, who earn substantial incomes during their playing years, deferring a portion of their compensation can offer several advantages.

First, deferred compensation allows (very) highly compensated individuals such as athletes to mitigate their tax liabilities. By deferring income to a later date, athletes can potentially reduce their taxable income during their high-earning years. This can be particularly advantageous for athletes who may be subject to high tax rates due to their significant earnings.

Second, deferred compensation provides athletes with a financial safety net for the future. Professional sports careers are notoriously unpredictable, with injuries and fluctuations in performance posing risks to athletes' earning potential. By deferring a portion of their earnings, athletes like Mr. Bonilla can ensure a steady stream of income during retirement, helping to maintain their lifestyle and support their families long after they hang up their cleats.

Moreover, deferred compensation can serve as a valuable tool for wealth accumulation and growth. Participants in these plans commonly can invest their deferrals in a variety of vehicles, such as mutual funds or company stocks. By harnessing the power of compounding returns over time, deferred compensation can significantly increase an individual's wealth and financial security.

However, it's essential to approach deferred compensation with careful consideration and planning. There are inherent risks to deferring compensation. Working with experienced financial advisors and tax professionals can help navigate the complexities of deferred compensation and maximize its benefits.

Deferred compensation programs represent a valuable financial strategy for professional athletes and executives alike. By deferring a portion of their earnings, these highly paid individuals can enjoy tax advantages, build a financial safety net, and create opportunities for wealth accumulation and growth. However, careful planning and diligence are essential to maximizing the benefits of deferred compensation and securing long-term financial security beyond the playing field or the board room.

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